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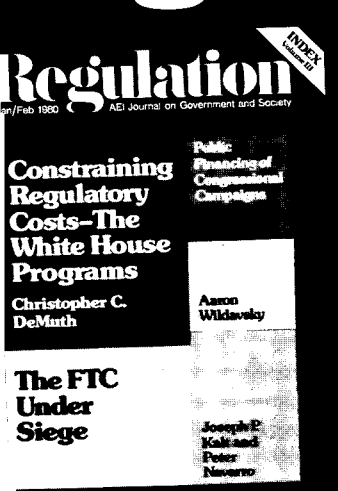
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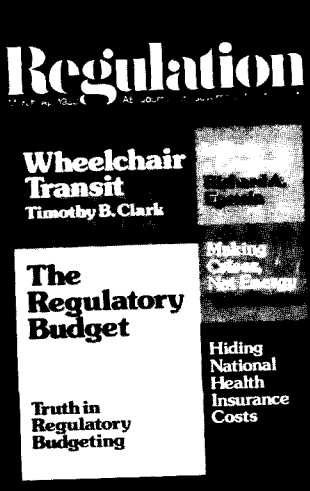

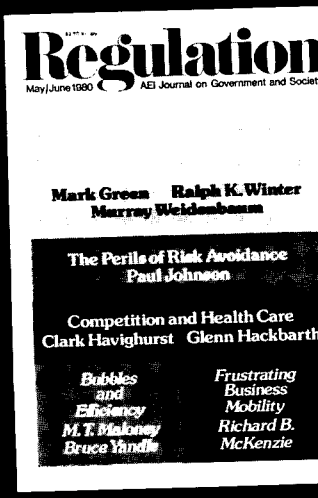

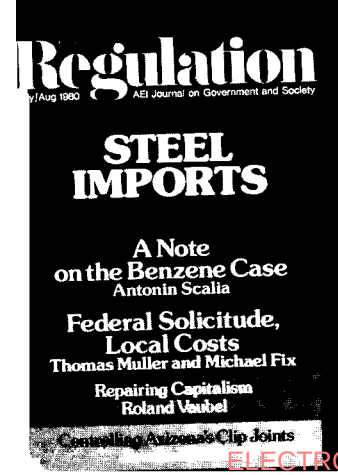

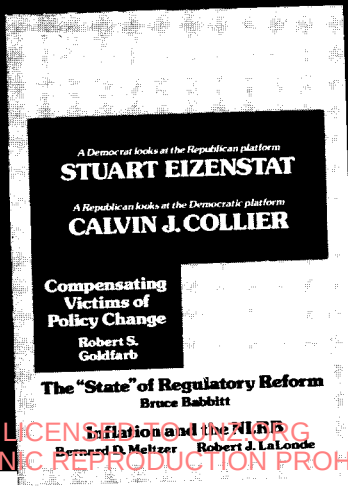
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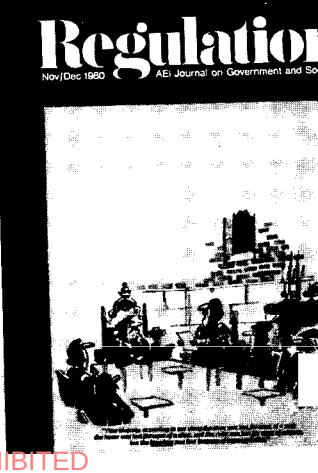

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Regulation

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Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

Compensation Programs

TO THE EDITOR:

In his insightful article, "Compensating Victims of Policy Change" (*Regulation,* September/October) Robert Goldfarb correctly points out that any explicit rationale for awarding compensation would likely be unable to contain pressures for even broader generosity. This warning applies particularly to the argument most often heard for compensation: that it would facilitate desirable policy changes otherwise difficult to accomplish. Adherents to this theory should recognize that compensation can also facilitate policy changes they might view as undesirable. Indeed, the ability of a compensation program to silence the opponents of policy change may be the strongest argument against it.

Often the deregulation of an industry is cited as an example of the kind of policy change that could be effected more smoothly with compensation. But if victims of deregulation were routinely compensated, could the victims of *increased* regulation be turned away? Section 25 of the Toxic Substances Control Act orders EPA to report to Congress on the desirability of indemnification (compensation) for victims of environmental regulation. (This study is now overdue.) Indemnification presumably could apply to stockholders who were injured, as well as to jobholders. One can imagine regulatory agencies using public funds to buy a consensus: paying proponents of stricter regulation to argue in favor of it, through intervenor funding, while paying the victims *not* to argue against it, through indemnification.

Fiscal expenditures are already out of control because their cost to individual taxpayers (and voters) is so diffuse. The visible anguish and cries of protest of the victims of regulation appear to be the most effective constraint on excess regulatory zeal; let us not smother them by shifting regulatory costs to the shoulders of the already overburdened taxpayer.

Brian F. Mannix,
Council on Wage and
Price Stability

TO THE EDITOR:

. . . Goldfarb points out that demands for compensation in many programs have expanded far beyond their originally intended boundaries, and that other programs have created disturbing incentives to engage in uneconomic behavior. This does not mean, however, that the government should abandon its efforts to compensate the victims of policy changes. *Any* change in policy will produce both winners and losers, and when the losers are numerous, or well-positioned politically, they usually succeed in blocking an uncompensated policy change even when the aggregate benefits of that change are very large in relation to their own losses.

More important, even when prospective losers are *not* numerous or well-positioned, they are still often able to block changes because of the very high premium our society places on what we may call "incumbency rights." The sentiment that underlies our legal maxim that "possession is nine-tenths of the law" also causes our political system to weigh the rights of parties adversely affected by policy changes much more heavily than those of parties who stand to gain. In view of these implied incumbency rights, carefully designed compensation programs are often the *only* practical way to achieve policy changes that pass even the most conservative cost-benefit standard.

Many of the flaws in the compensation programs Goldfarb discusses stem from our tendency to stress fairness as the exclusive rationale for compensation. These problems could be reduced sharply if we would eschew fairness altogether as an explicit rationale for compensation and adhere instead to the following rule of thumb: When an output-increasing policy change can be achieved politically without the use of compensation mechanisms, we should not use them; but when change is politically *impossible* without compensation, we should arrange lump sum payments of as small a size as is politically necessary to achieve the policy change.

Such a rule would help to close Goldfarb's Pandora's box, whose lid is currently propped open by our nearly exclusive reliance on explicit fairness considerations. No longer would consistency require that we track down secondary and tertiary victims of policy changes and debate what it would take to make them whole again. Nor would we be forced, say, to pay compensation only to those workers who remain unemployed after a trade liberalization on the grounds that it would be unfair to compensate workers who quickly found new jobs. Instead, efficient severance payments could be used in place of open-ended unemployment benefits to win union acceptance of trade liberalizations.

This would not eliminate fairness considerations from the compensation debate. Indeed, under the proposed rule, victims of policy changes would voice their demands for compensation through the political process in much the same way as they do now. The effect of the rule, to the extent that it enjoyed broad support, would be to clarify the policy debate and make it easier than it currently is to say no to compensation demands that have built-in incentives for inefficient behavior.

Would it be possible to secure broad political acceptance of the proposed rule of thumb? Two fundamental considerations suggest that it would. First, it is in the interest of all parties to agree *ex ante* to policy guidelines that discourage inefficient behavior. The larger the pie, the larger everyone's slice is likely to be. Second, those groups with the greatest political influence, and thus those whose support for the proposed rule would be most necessary, are those least likely to be threatened by the rule.

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Some may complain that the proposed rule is a cynical exercise in *realpolitik* that shortchanges the legitimate rights of the politically downtrodden. They should remember, however, that our current focus on nominal fairness has prevented us from making output-increasing policy changes in a host of different areas, which is itself unfair to the overwhelming majority who would benefit from such changes. We may also bear in mind that ours is a society that has always shown compassion toward the disadvantaged, never more so than in times of rapidly growing national output. Any policy that makes it easier to achieve output-increasing changes should therefore make it easier to achieve commonly held equity objectives.

Robert H. Frank
Cornell University

TO THE EDITOR:

Most economists have had the lesson drummed into their heads that a policy change can be said to lead to an actual (as opposed to a potential) improvement in welfare only if compensation is paid to losers. Robert Goldfarb's article raises many thorny philosophical and practical issues which proponents of any compensation plan must confront.

The subject is particularly important since the government now awards compensation rights not only when it acts, but when it fails to act. For instance, the Trade Act of 1974 compensates workers and firms that are displaced when the government fails to impose new import curbs such as orderly marketing agreements and trigger prices. (Compare this with a narrower standard which would grant compensation only when tariffs are actually reduced.) TAA payments have accordingly ballooned into a program with estimated expenditures of $4 billion in fiscal 1981 (*Wall Street Journal*, November 14, 1980).

Yet we should evaluate the current TAA program in light of the high cost of alternative policies. Thus, a recent FTC analysis has estimated that the auto import restrictions proposed by Ford and the United Auto Workers would cost consumers $4 to $6 billion annually. Allowing for similar losses in other industries that demand protection would put current TAA expenditures in a more balanced light....

Postponing a decision to deregulate or to pursue freer trade not only requires us to forego benefits, but, as Goldfarb recognizes, may do nothing to reduce future demands for compensation. In particular, if a new cohort of workers is attracted into a protected industry, the demand for compensation could grow as it is postponed.

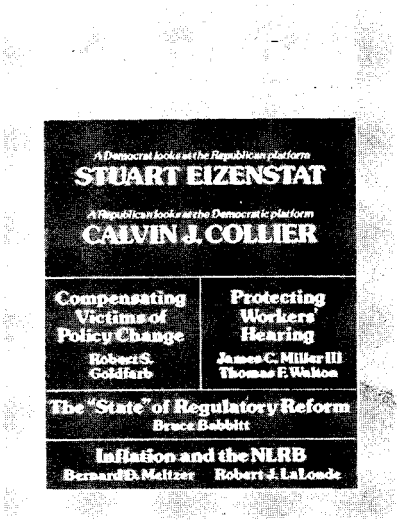
While it is clear that compensation plans raise a myriad of difficult design problems, scrapping the whole concept would eliminate a potentially useful economic policy tool.

John Mutti
University of Wyoming

ROBERT GOLDFARB responds:

All three letters make useful points. Mannix ingeniously identifies a hidden danger in using compensation as a policy tool that had not occurred to me. Frank stresses the fact that, despite all the pitfalls inherent in compensation policy, it may still be a useful tool in certain cases. He argues that many pitfalls could be minimized if compensation were not used as a "fairness" device; instead, compensation should only be used for political buyout purposes, and only when (desirable) change is politically impossible without compensation. Moreover, the compensation that is paid should be as small as politically possible (and lump sum). I strongly agree that this type of limitation on compensation policy is desirable. However, I am skeptical about the ability of the political system to successfully impose it. It is just too politically tempting to give out goodies when harm is claimed. If my skepticism is correct, the issue becomes an empirical one. Assuming that we have the political choice of *sometimes* using compensation policy versus *never* using compensation policy (a choice we may not in fact have) and assuming we try our political best to enforce Frank's limitations on compensation applicability, will net benefits from appropriate use of compensation outweigh net costs from inappropriate uses? Reasonable observers may well disagree on the answer to this question.

Mutti's letter provides an interesting counterpoint to Frank's. Mutti, like Frank, argues that despite its various difficulties, compensation policy may be useful in some cases. He cites TAA as an example of a program that looks expensive, but may in fact be a worthwhile "deal" since it may have forestalled the imposition of much more costly import restrictions. This line of argument seems to suggest two important questions: (1) Has TAA *in fact* significantly lessened effective protectionist pressure? Mutti is far better equipped to answer this question than I am, but recent newspaper accounts of pressure for automobile protectionism from organized labor do not leave me convinced that the 1974 Act was highly effective in limiting pressure for protectionism; and (2) Even if TAA has in fact lessened effective protectionism, has it met Frank's demand for "efficient buyouts"? That is, does the current TAA program appear to be a "least cost" way of buying acquiescence to not increasing trade barriers? I'd be surprised if the answer were "yes." In any case, both questions seem to me to deserve careful study.



Inflation and the NLRB

TO THE EDITOR:

Bernard D. Meltzer and Robert J. LaLonde, in "Inflation and the NLRB," (*Regulation*, September/October) have put their fingers on a little-noted means by which inflation broadens the scope of national labor law regulation: the dollar business volumes used by the NLRB to define the minimum scope of its jurisdiction over employers, figures which Congress froze into a statutory mold in the Landrum-Griffin Act of 1959.

An important theme in recent

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analysis of the NLRB is the urgent need for deregulation. Typically, this debate is conducted with reference to qualitative board doctrines—particularly the extensive battery of regulation of election campaign propaganda. . . . Meltzer and LaLonde show how inflation has been producing a continual quantitative expansion of the scope of board regulation as it erodes the real value of the monetary standards fixed more than two decades ago (in the days of relative price stability of the fifties).

Almost in passing, the authors seem to endorse indexing the board's jurisdictional standards as a remedy. I agree that we do need to ration the scarce resources of national labor law and administration. I also agree that if we are to adopt monetary criteria for this purpose, then we should use some index or other to preserve the real, not simply the nominal, value of the figures we initially select. I suggest, though, that as and when Congress addresses this problem, it should rethink the issue of whether the amount of business a firm does (e.g., a $500,000 sales volume for department stores) is the proper criterion for determining whether its employees are to be protected from discriminatory anti-union firings or its business is to be protected from secondary organizational picketing.

Of course, one could reply that these jurisdictional limits do not evidence a substantive judgment about the appropriate legal rights of employer and employee in small businesses. Rather they reflect a view only of the proper reach of federal law, and thus leave it to the states (explicitly under Section 14(c) of the NLRA) to step in to fill the vacuum. The problem is that too many of the states have not done so. One reason is that under the current constitutional and statutory interpretation of federal power under the interstate commerce clause the national labor law penetrates so deeply into the world of employment (even in terms of 1959 dollars), that it has left the states little or no incentive to provide sophisticated legal and administrative protection for the marginal situations which elude this federal net.

Indexing the jurisdictional standards to the rate of inflation would simply reinforce the current pattern. I prefer quite a different approach. There should be a radical hike in the floor of the NLRB's jurisdiction: to somewhere on the order of $10 million business volume or 500 employees. But this self-limitation of federal labor law should apply only in regard to those states which actually do exercise their right to enact a comprehensive labor statute, one which addresses the relevant problems within the principles of the NLRA (although certainly not with slavish imitations of the latter's detailed rules). I know that there are serious issues to be faced in working out any such approach, issues which cannot be dealt with in a letter of this length. But I believe this tack does exhibit two important virtues lacking in the current setting. First, there would be a major, not just a marginal, contraction in the work of the NLRB which would enable the latter to focus its resources and energies in faster and more thoughtful disposition of the caseload which it retains. Second, we would invite the states back into the business of labor law reform, in an effort to break the current logjam at the national level. The Agricultural Labor Relations Act enacted in California in the mid-seventies shows that the states, if given the opportunity, can devise innovative approaches to the perennial problems of private sector labor law (such as union access to workers, expedited elections, and so on). I hardly think it likely that there would have been an ALRA if California had been left with jurisdiction only over the smaller farms which fell beneath a national monetary standard for the NLRB's jurisdiction, even if that standard were indexed to the rate of inflation.

Paul C. Weiler
Harvard Law School

BERNARD MELTZER responds:

Our article was concerned essentially with the impact of inflation on the NLRB's jurisdiction. Professor Weiler's proposals are more ambitious — and interesting — and they call for a bit of background.

The Taft-Hartley Act permitted the NLRB to cede jurisdiction to state agencies unless it found the pertinent state and federal provisions to be inconsistent. The NLRB, however, never found the requisite conformity. The areas which the NLRB itself declined to regulate were also held to be beyond state authority, thus creating the notorious no man's land, which was eliminated in 1959.

Professor Weiler's more flexible proposal has the defects of its virtues. First, since the NLRA states its "principles" with a pliable generality, their actual impact depends critically on continuing interpretation as well as on procedural rules. The tribunal or tribunals (which, incidentally, he does not specify) examining state conformity to federal principles could, of course, stress merely the verbalistic conformity of state and federal statutory provisions. But if such a tribunal were also to compare the actual impact of the whole body of federal and state decisions, complex controversies would proliferate, without clear-cut legislative standards for resolving them. After all, one man's "detail" is another man's "principle." In any event, it is unclear what effect his proposal would have on the jurisdiction of the approximately 15 existing state labor boards. What is reasonably probable is that cases excluded from national jurisdiction arriving in "non-conforming" states would once again be relegated to the limbo of no man's land.

Second, his proposal would further complicate state adjudication, since a state agency would often face the risk that deviation from federal principles in a particular case might destroy state jurisdiction.

Finally, Professor Weiler's proposal lacks any clear grounding in principle. If the federal interest is strong enough to require the application of federal principles to all or a given class of cases, the rules and adjudication that give content to those principles should also apply. (If such absolute conformity imposed an excessive workload on the federal board, other measures —which I cannot treat here—could deal with that problem.) On the other hand, if the matters excluded from the national board are predominantly matters of local interest, the states should be free to experiment, subject only to the Constitution—and not to a rule permitting them to depart from the federal model, but not too much. The states should also be free to develop new approaches to any problems distinctive to smaller firms. That there is no obvious line between local and national labor disputes does not justify hazy demarcations between state and federal jurisdiction.

It may be true, as Professor Weiler suggested, that the federal net is now cast too wide to provide an adequate incentive for state labor law reform. But the inaction of the states is not simply the result of the

(Continues on page 53)

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Perspectives
on current developments

The Cotton Dust Case

The regulation of cotton dust—or, perhaps more accurately, the threat of the regulation of cotton dust—has had a long and illustrious history at the Occupational Safety and Health Administration. In 1972, OSHA Administrator George Guenther urged his Department of Labor superiors to use the threat of a Democrat-imposed cotton-dust standard as a means of raising contributions for President Nixon's campaign. At the same time the unions, supported by Nader groups, were using the cotton-dust issue to help organize the southern textile industry. Cotton dust is alleged to cause a respiratory disease called byssinosis or, colloquially, brown lung—although, in fact, byssinosis does not affect lung pigmentation.

The standards were not formally proposed until December 1976 (see "OSHA and Work-Place Hazards: Cotton Dust," *Regulation*, July/August 1977). They called for tightening worker exposure to cotton dust from 1.0 milligram per cubic meter of air to 0.2 milligram, solely through the use of engineering controls (in this case, air-cleaning equipment).

A final cotton-dust regulation was issued by OSHA in June 1978 after a bitter battle within the Carter administration, fought out before the nation in a series of leaked memos reported in the *New York Times* and *Washington Post*. (See Susan Tolchin, "Presidential Power and RARG," *Regulation*, July/August 1979, and Christopher DeMuth, "Constraining Regulatory Costs—The White House Programs," *Regulation*, January/February 1980.)

On one side of the dispute, the Council on Wage and Price Stability and the Council of Economic Advisers argued that the costs of the proposed engineering standards were too high and the health benefits too low when compared to the alternatives. Specifically, they claimed that a performance standard allowing the use of personal protective devices (respirators), medical monitoring, and administrative measures (rotating work shifts, for example) would be more cost-effective. On the other side, OSHA, the AFL-CIO, and some press reports (not to mention a Twentieth Century–Fox movie) argued that byssinosis was as deadly to the textile mill workers of the South as black lung was to the coal miners of Appalachia, and that drastic restrictions on cotton-dust exposure were justified.

Actually, there is reason to believe that OSHA was caught off guard by the vehemence of the White House economists' objections. OSHA thought that the rule it was ready to issue already reflected considerable concessions on the cost side, skillfully walking a tightrope between the labor unions and a President whose political support was based in the cotton-growing and textile-producing South. The agency had adopted CWPS's recommendation that permissible exposure levels for different segments of the industry be structured according to cost-effectiveness considerations. Instead of its original proposal for an across-the-board exposure level of 0.2 milligram per cubic meter of air, OSHA had agreed to prescribe levels that varied from 0.2 to 0.75 milligram for different stages of cotton processing.

The adoption of a variable exposure level policy was unprecedented for OSHA—and reduced the annual costs of compliance to $200 million compared to $700 million for the original policy. However, CWPS and CEA were still not satisfied. They argued that another $125 million could be pared from annual compliance costs if the engineering standards were relaxed further in favor of respirators and medical surveillance techniques. The economists pointed out that byssinosis is not an irreversible disease, as is cancer, but a reversible condition that progresses slowly over many years from occasional temporary chest tightness to chronic obstructive lung disease. The disease strikes only some individuals, gives plenty of warning,

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and can be almost totally reversed if the victim is removed from the dust-laden environment.

The internal battle raged for about a month, complicated by court-imposed deadlines, threats of resignation, and full coverage in the newspapers (including pictures of White House economists working at their desks wearing respirators). Finally, after initially agreeing with the economists' performance-standard approach, President Carter made an about-face and sided with Secretary of Labor Ray Marshall. Predictably, the American Textile Manufacturers Institute (among other business organizations) challenged the rule in court, and the AFL-CIO also sued, claiming that OSHA's standard was not stringent enough.

In October 1979, the U.S. Court of Appeals for the District of Columbia upheld OSHA's standards in a three-to-zero vote. OSHA Administrator Eula Bingham proclaimed: "This decision vindicates our regulatory approach favoring engineering controls over personal protective equipment." But the story was not over.

The Supreme Court granted the industry's petition for an appeal on October 6, 1980, and will hear the case this session. A decision is expected in late spring or early summer. It is widely hoped that the Court will address the question of whether OSHA must find a reasonable relation between the benefits of its health standards and the attendant costs. Just last summer the Court ducked this question in its benzene decision, by finding that before the cost-benefit issue is even reached, the agency must at least establish a significant health risk addressed by the rule—which, in that case, OSHA had not done. (See Antonin Scalia, "A Note on the Benzene Case," *Regulation*, July/August 1980.)

At the time the benzene case was decided, it was generally believed that the coke-oven emissions case then on the Court's docket, *American Iron and Steel Institute* v. *OSHA*, would present the cost-benefit issue in the present term; inexplicably, however, the steel industry withdrew its appeal. (It has filed an amicus brief in the cotton-dust case.) From a tactical standpoint proponents of cost-benefit balancing may prefer the cotton-dust case, in any event. Unlike the cancer linked to coke-oven emissions, byssinosis, at least in its early stages, is not an irreversible and disabling disease—so that the instinctive revulsion against "weighing costs against human lives" may not affect the Court as significantly.

In the cotton-dust case, the Supreme Court will not be able to employ the same device that it employed in benzene to evade the cost-benefit issue. On the basis of the record before the Court, it would be extremely difficult to maintain that no significant health risk has been established; and none of the litigants opposing the rule is even arguing that point. The cost-benefit issue can be avoided in another fashion, however: While OSHA denies the necessity—and even the permissibility—of conducting any cost-benefit balancing, it acknowledges that costs must be estimated in order to establish that they are not so high as to bankrupt the industry. Petitioners maintain that, even for this limited purpose, OSHA's determinations were inadequately supported by the record. If the Court agreed on that point, it might once again avoid reaching the more general issue of cost-benefit balancing.

The final irony in this case may be that the technical information that might settle the question of whether the cotton-dust standard is good public policy cannot be considered by the Court, since it is not part of the record. In a recent study, two researchers from Duke University Medical Center—the same institution that provided the studies on which OSHA based its final standards—found that nonsmokers and ex-smokers have almost no risk of experiencing irreversible disabling degrees of byssinosis even with continued exposure to cotton dust. (See Siegfried Heyden and Philip Pratt, "Exposure to Cotton Dust and Respiratory Disease," *Journal of the American Medical Association*, October 17, 1980.) Thus the "material impairment" required by the Occupational Safety and Health Act (subsection on toxic materials) before health standards are to be promulgated may be caused by smoking—not cotton dust.

Department of Anticipated Consequences

Women, it is said, live longer than men. They also have fewer auto accidents. Under the provisions of legislation now pending in Congress, providers of insurance, pensions, and annuities would be barred from using sex-related factors of this sort in determining rates and benefits.

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The Non-Discrimination in Insurance Act (H.R. 100) would prohibit discrimination in every kind of insurance on the basis of race, color, religion, sex, or national origin. Because the other classifications are not currently used by insurers, the bill would require changes only in cases where gender is used as a classification. The proposed law would require the redistribution among consumers of massive amounts of costs and benefits, and (the insurance industry asserts) some absolute cost increases. It would require the adoption of unisex actuarial tables, the equalization of rates and benefits, and—in the case of pensions and annuities—increased premiums for women who begin receiving benefits after the law's enactment above and beyond the benefit rates called for in the original contracts.

Proponents of the bill argue that the use of gender as an insurance classification is inherently unjust and that the categories themselves often have little meaning. In current practice, insurers do discriminate between men and women; the bill's proponents argue that insurers also discriminate *against* women. Their claim is that insurers ignore other, more accurate rating classifications, such as family health history, physical conditions, and so-called life-style considerations (for example, smoking habits and recreational and occupational activities). The proponents also draw the predictable parallel with racial discrimination, arguing that race is at least as good an indicator of life span as is sex. If insurers do not use race as a classification, then why should they use sex, or to put it more wickedly, if they use sex why not use race too?

The industry responds, first of all, that sex is only one of many classifications it uses, and that it does indeed use "life style" and other factors in setting rates and benefits. As for race, the industry says that to the degree that racial classifications would be useful they are already taken into account in other classifications. Blacks have shorter average life spans not because they are black, but because of the very life style and socioeconomic factors that are now used to classify risks. Sex is a useful and valid classification, the industry argues, precisely because the physical differences between the sexes do have consequences.

H.R. 100 would not be an unqualified economic boon for women. The financial effects of prohibiting classification by sex would be mixed. Women would be favored in the case of pension and annuity contracts that they purchase, since as a class they would receive higher annual benefits than they do now but the increased premiums necessary to cover the higher benefits would be borne equally by men and women. With respect to straight life insurance, on the other hand, women as a class would clearly lose, because their benefits would not be raised but their annual premiums would be (since it would no longer be lawful to assume that they make payments during a longer lifespan). And with respect to auto insurance, the adverse effect on women as a class might be striking: The industry estimates that male drivers have 70 percent more accidents than females, and prices its policies accordingly. In other words, if in fact sex is an accurate determinant of such matters as life span and accident proneness but is not permitted to be taken into account, women would in some cases be subsidizing lower rates for men.

For all insurance and annuity coverage paid for by employers, H.R. 100 would seem unnecessary to produce the foregoing results—however desirable or undesirable those results may be. For in 1978, in *City of Los Angeles* v. *Manhart*, the Supreme Court held that an employee annuity plan which provides both sexes equal periodic benefits after retirement, but requires women (because of their longer life expectancy) to make larger periodic payments during employment, violates the provision of Title VII of the Civil Rights Act of 1964 that prohibits sex discrimination in employment. There have been some attempts to give a narrow interpretation to *Manhart*, but they fall within the category of the wish fathering (oops, parenting) the thought.

One feature of the bill would provide a substantial windfall for current female employees past or near retirement age. In a provision that displays Canute-like insouciance for the tidal principle that contribution must equal pay-out, the law would require equal pay-outs for men and women who retire ninety days after its enactment, but would not permit (even if it constitutionally could) any *reduction* in the pay-outs for men. This would mean, of course, that retirement funds would be confronted with an immediate obligation that had not been provided for by past contributions,

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and it is unclear where the money is supposed to come from. Even without H.R. 100, the Equal Employment Opportunity Commission is attempting to perform the same economic prestidigitation under the authority of *Manhart*: it is currently pressing the Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), one of the largest pension funds in the country, to pay equal benefits to men and women who have already retired.

Some of the implications of prohibiting sex-based statistics throughout the insurance industry are potentially significant but difficult to predict. As noted earlier, for example, in the field of auto insurance women drivers paying equal premiums would be subsidizing men. So presumably insurers would seek out the patronage of women, who would be paying high premiums relative to risk, and avoid males, whose premiums would be lower than the real cost of insuring them. The industry predicts that more drivers would wind up in the "assigned risk" pool, where rates are much higher, as companies sought to bring risks and rates into alignment. With respect to life insurance and annuities, on the other hand, it may be that elimination of sex-based statistics would not have a significant distorting effect. Critics of the current practice argue that insurers have simply exaggerated life-span differences and that sex is indeed a "spurious, weak, and unstable predictor of mortality" (see Readings, page 49).

Except insofar as the issue of unlawful or improper discrimination is involved, it is difficult to see how any of this is the government's—especially the federal government's—proper concern. If sex is in fact a weak or invalid determinant of particular insured events, surely the insurance companies themselves (assuming they are subject to either rate regulation or competition) have every incentive to avoid it. In any case, it would surely help to have a legislative judgment more specific than the vague Title VII prohibition interpreted, perhaps correctly, in *Manhart*, as to whether this sort of sex-based generalization constitutes "discrimination" and is meant to be unlawful. Perhaps the main function to be served by H.R. 100, assuming it survives the new Congress, is to provide such a judgment.

More Governmental Innovation from the Golden State

On July 1, 1980, the California Office of Administrative Law came into existence. Its ominous mission (ominous, that is, for other state agencies) is suggested by the legislative finding that begins its enabling act: "The Legislature finds and declares as follows: . . . There has been an unprecedented growth in the number of administrative regulations in recent years."

OAL is an independent agency whose director is appointed by the governor of California for a term coextensive with his own. Its task is to review all new regulations issued by state agencies before final publication to ensure, among other things, "(a) Necessity. (b) Authority. (c) Clarity. [and] (d) Consistency [with existing laws]." Over the next six years, OAL will also get a chance to review all existing regulations. If a regulation is found wanting, it is returned to the agency for revision—or burial. The governor may veto OAL disapproval, except in the case of "emergency" regulations, where OAL's word is final.

Interestingly, while agencies must ask OAL's consent to add new regulations or amend old ones, they are free to repeal regulations whenever they want to. This feature, combined with the requirement for six-year review of all existing regulations, reduces the tendency of such a control device to "freeze" existing regulation (see Antonin Scalia, page 13, this issue). Moreover, to add insult to injury, other state agencies must reimburse OAL for the cost of its "services"—a requirement giving OAL some insulation against budget cuts by legislators sympathetic to frustrated regulators.

For some reason (perhaps the unprecedented growth in the number of statutes in recent years?), the new law and the new agency initially attracted little attention. But now the bureaucratic fur has started to fly. OAL has told the Fish and Game Commission that it cannot protect butterflies under the California Endangered Species Act (which does not cover insects) because, contrary to the view of the commission, insects are not fish under California law (honest!). It has found the State Athletic Commission's proposal for a disability insurance program for boxers badly worded and unclear. It has also found that the Board of

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Medical Quality Assurance had not adequately shown a need for new regulations governing licensed physical therapists. It has even rejected attempts by several agencies to avoid public hearing requirements by issuing regulations as "emergency" measures, a category that included a quarter of the California regulations adopted last year. As of the end of 1980 it had rejected, on one ground or another, one-fifth of all proposed new regulations.

The State Athletic Commission, appropriately the most pugnacious of the challenged agencies, went (so to speak) to the mat with OAL, charging it with "impudence" and with going beyond its assigned "housekeeping functions." The commission threatened to challenge OAL to the Ultimate Contest—in the courts—only to discover that OAL's enabling legislation forbids agencies to take it to court.

OAL may well be King of the Mountain. Think what President Carter's Regulatory Analysis Review Group would have given for the power to review and veto regulations on the basis of "necessity"! But, alas, the matter is not all that clear: The California law states that OAL should not "substitute its judgment for that of the rulemaking agency as expressed in the substantive content of adopted regulations." How one can disagree with the "necessity" for a proposed rule without performing such substitution is a mystery whose solution was once, presumably, known to the California legislature but now is known only to the courts.

For the time being, OAL seems inclined to follow a modest strategy, simply requiring that agency rulemakings be thoroughly documented and disallowing some of the more egregious regulatory examples. It claims to have found most state agencies cooperative. But, bureaucratic incentives being what they are, sooner or later an activist OAL is likely to test the legal limits of the "necessity" standard.

The concept of a Regulation Czar is, of course, somewhat scary—unless one views that as precisely the role which the elected chief executive (governor or president) is supposed to play. Such review "from the top"—outside of the special-interest confines of the issuing agency, and at a level where all the affected social interests can be taken into account—may be the only ultimate remedy for a government that, in the era of agency-made law, has as many unrepresentative mini-legislatures as it has letterheads. One would have thought it more appropriate to lodge the regulation-reviewing authority directly in the chief executive, rather than merely giving him veto control, as the California law specifies. Still, one should hope that OAL's authority will be broadly interpreted. It will provide a good test, for other states and for the federal government, of centralized executive review as a control device.

Competition in Kidney Dialysis

A mild form of competition has broken out in one corner of the medical services field, but new regulations proposed by the Health Care Financing Administration may succeed in remedying the problem. According to the Council on Wage and Price Stability, HCFA's proposed reimbursement scheme for kidney dialysis treatments would subsidize high-cost providers and drive low-cost competitors from the field.

Renal dialysis treatments are necessary three times weekly to sustain the lives of the 57,000 Americans afflicted with end-state renal disease. In hemodialysis, the predominant form of treatment, the blood is cleansed of impurities by pumping it through a semi-permeable membrane for four to six hours.

In 1978 the annual cost of dialysis was about $25,000 per patient, a sum beyond most patients' means. To broaden access to dialysis, Medicare coverage was statutorily extended in 1972 to fund treatment for virtually all patients who would benefit from it. As a result, the Medicare dialysis population grew from 11,000 in 1973 to about 50,000, and now encompasses nearly 90 percent of all patients with end-state renal disease. Program costs also increased—from $283 million in 1974 to $1.08 billion today—but the rise occurred entirely because of inflation and an increase in patients: by the calculations of one expert, R. A. Rettig, average benefit payments per patient, adjusted by the medical component of the consumer price index, actually fell nearly 10 percent.

Outpatient dialysis is provided by hospitals and by independent free-standing dialysis facilities (FSDFs)—specialized clinics that provide only dialysis services. Most of these clinics are operated for profit and, according to some critics, are very profitable indeed. The Health Care Financing Administration, which runs the

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In Brief–

Carcinogen of the Month. Carcinogen fanciers will be thrilled to learn of a newly discovered cancer-causing substance that will surely be a choice addition to their collections, no matter how extensive these may already be. This white crystalline chemical, derived from a tropical crop, was tested in a careful study carried out by the Huntingdon Research Centre in Huntingdon, England (under contract to the Swiss drug firm, Hoffmann LaRoche). A statistically significant increase in the incidence of liver tumors, both malignant and benign, was observed when the substance was administered to female CFLP mice for two years at a dietary concentration of 20 percent—a level which, rather than debilitating the mice as in tests of so many other substances, actually caused them to thrive. (Mice that survived to the end of the study gained 15 percent *more* weight than untreated mice!)

This clearly hazardous chemical has been used as a food additive for many years and is officially classified "Generally Recognized As Safe." That classification, however, must be considered in grave danger; indeed, under the Delaney clause, the use of the substance in foods must now be banned. It is widely added to salad dressings, cereals, many cooked dishes, canned fruits, baked goods, ice cream, all flavored soft drinks (except those containing saccharin), and, so it is widely rumored, to wines from Burgundy. The substance in question is sucrose, also known as table sugar. (Details of the Huntingdon experiment are available from the FDA upon request.)

Isaac, Ishmael, and the Federal Courts. The exciting possibilities for classifying individuals by bloodline that have been opened up by political and judicial acceptance of affirmative action were demonstrated last August in forms sent to all federal courts by the coordinator of the Judiciary Equal Employment Program, Administrative Office of the U.S. Courts. The forms called for the courts to identify the "race/national origin group" of each employee and judicial officer—a request surely as American, nowadays, as apple pie. But, the accompanying memo pointed out, "please note that the category 'white' has been revised to reflect the subgroups 'Arabic' and 'Hebrew'." It was specified that these "distinct subgroups" were to be "based on ethnic, not religious, factors" — suggesting, presumably, a federal determination that ethnicity postdates Abraham.

Alas, what might have been a modest effort at gradually achieving truly proportional representation of all bloodlines in federal court employment evidently met with some opposition. A subsequent memorandum from the coordinator announced, in a phrase perceptive readers will recognize as having been copied directly from *The Bureaucrat's Handbook* (the chapter entitled "How to Back Down without Confessing Error"): "It has been determined that the breakdown of the category 'white' to reflect the Semitic subgroups (designated as 'Arabic' and 'Hebrew') will not be necessary." Too bad. That probably means that the timetable for identifying Greeks and Turks, Serbs and Croats, Flamands and Walloons will have to set back a few years.

Or might there have been some other purpose involved? Our guess is probably the same as yours—it was a devious way of asking "How many Jews are on your payroll?" We suspect that the ultimate pur-

program, reimburses hospitals for 80 percent of the actual cost of treatment and FSDFs for 80 percent of their charges. For both types of facility, there is a reimbursement "ceiling" of $138 per treatment. HCFA waives this ceiling, however, when a facility demonstrates that its actual costs exceed the combined total of the $138 ceiling and patient payments. Hospitals have labor costs that are about 30 percent higher than those of independents, and overhead and supply costs about 13 percent higher. Today, as a result, they routinely receive waivers, and their average reimbursement has risen to $160. FSDFs rarely need waivers, and their average is still $138.

According to Rettig's research, the ceiling was initially set too high. It remained unchanged, however, during the inflation of the subsequent years, so that it eventually began to force maintenance dialysis out of hospitals and into the lower-cost FSDFs. By 1977, almost 45 percent of all dialysis treatments were being provided outside hospitals. The ceiling also led, Rettig says, to the introduction of cost-saving technology. Newer large-surface dialysis machines reduce a session from six-to-eight hours to about four. But to the extent that full cost waivers for hospitals become routine, the ceiling loses its effectiveness.

On September 26 HCFA proposed new regulations allegedly designed to establish an "incentive reimbursement system" for dialysis services. The proposal would formalize and extend the differential treatment of hospitals and FSDFs, setting the reimbursement level of each at the median of all historically determined

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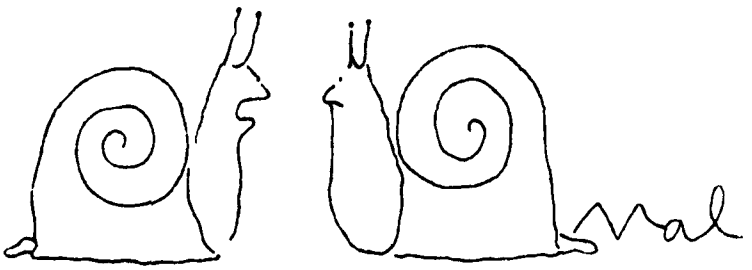
pose was thought to be benign—namely, to find out whether there are any courts in the country that have an anti-Semitic (Arabs excluded) hiring record. And we further suspect that the most vociferous opposition which led to the determination that the breakdown will "not be necessary" came from the supposedly benefited group itself—which has reason to believe that, down the road of official classification by blood, there ultimately lie denial of equal opportunity, social fragmentation, and worse.

Quis Custodiet Ipsos Custodes? Firms in the private sector who have seen expansion or production plans frustrated by environmental laws can take some wry comfort in the fact that even implementation of the environmental laws is sometimes frustrated by environmental laws.

The Environmental Protection Agency is currently appealing, to the U.S. Court of Appeals for the Ninth Circuit, a judgment won by the Pacific Legal Foundation halting EPA-mandated modifications to the sewage treatment plant operated by the City of Los Angeles at Hyperion. The modifications would have halted the plant's discharge of sludge into Santa Monica Bay, requiring it to be hauled to a landfill for disposal.

It turns out, however, that Santa Monica Bay is the habitat of the Pelicanus Occidentalis (California Brown Pelican) and that land close to the plant is the stamping ground of the El Segundo Blue Butterfly—both of which creatures are protected by the Endangered Species Act. According to the district court, EPA ran afoul of that legislation by failing to give consideration to the effects of its action upon the protected wildlife. The Department of Interior (charged with enforcing the Endangered Species Act and joined as a defendant because of its alleged failure to do so) had noted that during the construction period for the EPA-mandated modifications, pollutant discharge into the bay would actually be increased. Beyond that, the plaintiff charged that the ol' Pelicanus Occidentalis actually *likes* the sludge—or more precisely the marine organisms that he likes like it—so that it would be good to detoxify the sludge but not eliminate it from the bay.

Underlying the suit is a somewhat more general issue: the Pacific Legal Foundation claims that the Interior Department has displayed a "pattern of nonfeasance" in failing to enforce the Endangered Species Act against EPA. We think Interior should clear its name by going after EPA on a snail darter rap. ■



"That's the government for you . . . millions for the snail darter, and zilch for the snails!"

costs for its class. Both types of facility would be paid a fixed, pre-determined fee without regard to actual costs—with some rather notable exceptions.

The idea behind fixed reimbursement, both the current scheme and HCFA's proposal, is to prevent hospitals from automatically passing costs on to Medicare. If costs exceed the reimbursement level, a hospital must either absorb the excess or discontinue outpatient dialysis; but if it can get its costs below that level, it keeps the resulting savings. Such savings, in theory, are eventually shared with Medicare and with patients because new providers enter the field and bid away any excess profits. In addition, under the proposed scheme, the government would lower the reimbursement level as the median cost declined.

The Council on Wage and Price Stability maintains, however, that the new reimbursement policy has several serious flaws. First, because cost allocation in any multi-product firm involves many arbitrary judgments, it might be possible for hospitals simply to reassign excess costs to other Medicare programs that reimburse according to costs. Second, the proposal seems to allow too many exceptions. HCFA would grant exceptions to any hospital able to demonstrate that it had excess costs for any of four reasons: (1) its services were atypical, (2) its facilities were underutilized, (3) it had experienced extraordinary circumstances such as strikes, fires, floods, and earthquakes, and (4) it was the sole supplier in a community. HCFA does not have enough data to predict how many hospitals would qualify for excep-

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HOW MUCH WILL THE OPERATION COST, DOC?
FORGET THE COST, CLEVIS...
I'M GIVING YOU THE ECONOMY JOB.
WILL I PULL THROUGH?
NO, BUT THINK OF THE SAVINGS.
Bill Rechin

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tions under these criteria, but it is possible that the number would be large enough to raise the average reimbursement above present levels. All services now costing below the median would automatically be paid the median, while those above the median might be eligible for exceptions.

Third and most important of all, CWPS maintains that the establishment of entirely separate reimbursement rates for hospitals and FSDFs would be a mistake. Where both types of facility offer comparable services, public policy should direct patients to low-cost providers. If hospitals cost more merely because they pay higher wages or have greater overhead, they should be offered the same fee as FSDFs and thus discouraged from providing outpatient renal dialysis. Alternatively, if hospitals' costs are higher because their patients are more seriously ill and thus require different services, then fees should differentiate by services provided (treatment A vs. treatment B) rather than by facilities. This would foster competition and encourage efficiency, with specialization one possible outcome (hospitals offering only treatment A and independents only treatment B). But under HCFA's proposal, CWPS notes, because hospitals would be paid a higher fee regardless of whether they handled difficult or routine cases, they would have a strong incentive to increase their patient load by treating more routine cases while billing Medicare at the higher rate.

There is one other relevant economic factor that the new regulations do not take into account. Some researchers have found evidence of economies of scale in renal dialysis. If they are correct, HCFA ought to vary its fee according to the size of the market—that is, provide lower fees in densely populated areas to encourage (and take advantage of) economies of scale.

A final problem with the HCFA proposal is the existing certificate-of-need program by which the government limits the number of dialysis stations in a community. Such regulation is sometimes seen as a necessary evil in a cost-reimbursement system. But if a fixed-fee system were to be instituted, CWPS warns, regulation of entry would only increase costs by preventing competition from newer low-cost providers.

In a field not usually known for its competitive zeal, free-standing dialysis facilities are a refreshing anomaly. Their existence has been made possible by regulations which, in some ways, reward cost-effective dialysis. HCFA's proposal, if it would not ultimately lead to their demise, could at least perpetuate remaining inefficiencies and put a further drain on the Medicare Trust Fund.

Of course a more fundamental question relating to the solvency of the fund is the wisdom of a program that currently costs about $1 billion a year to benefit about 50,000 recipients—to a large extent the same 50,000 each year, and without restoring them to anything near full health. If that enormous additional sum is to be budgeted annually for health services, it seems implausible that greater results could not be achieved in some other area. Perhaps the attraction of the dialysis program is that its results (and the sad consequences of its elimination) are so immediately and particularly verifiable. But as medical science discovers more and more ways of prolonging life at fearsome expense, the need for the prudent weighing of alternatives—even in Medicare expenditures—becomes increasingly apparent.

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Viewpoint

Antonin Scalia

Regulatory Reform– The Game Has Changed

IN THE EARLY DAYS of the Ford administration, the Justice Department was having great difficulty filling a major vacancy at the political appointee level. The search had gone on in vain for a number of weeks when, at a staff meeting one morning, Attorney General (and renowned homespun wit) William Bart Saxbe announced that he had figured out why he was having so much trouble inducing a qualified Republican to accept a powerful and prestigious office. "It has to do," he said, "with the basic difference between Republicans and Democrats. I never fully understood it until someone explained it to me at a cocktail party last night—but once you hear the explanation it's entirely clear. The *basic* difference between the parties is quite simple: The Democrats want to run the country, and the Republicans don't want them to."

I have since come to call this profound insight the Saxbe Hypothesis—the proposition that the basic goal of the Republican party is not to govern, but to prevent the Democrats from doing so. It is applicable, of course, not merely to Republicans but more generally to all those who seek to reverse the trend of increasing government control over economic and social affairs. Distrustful of government in general and executive government in particular, they are not only less eager than their political opponents to grasp the levers of government power but are also inclined to view all impediments to the exercise of that power as a victory for their cause.

The Saxbe Hypothesis springs vividly to mind as one examines some of the supposed regulatory reform devices now under consideration in Washington. At a time when the GOP has gained control of the executive branch with an evident mandate for fundamental change in domestic policies, Republicans, and deregulators in general, seem to be delighting in the prospect of legislation which will make change more difficult. Those in the Congress seem perversely unaware that the accursed "unelected officials" downtown are now *their* unelected officials, presumably seeking to move things in *their* desired direction; and that every curtailment of desirable agency discretion obstructs (principally) departure from a Democrat-produced, pro-regulatory status quo. Their attitude promises to do major harm to the drive for genuine regulatory reform.

Item: The Bumpers amendment. This proposal would eliminate the traditional legal rule that, in reviewing administrative actions, the courts will give great deference to agency judgment, even on matters of law. The rule has enabled the Federal Trade Commission (FTC), for example, to impose some very expansive notions of what constitutes "unfair or deceptive trade practices." It would be bad enough, from the viewpoint of an enlightened deregulator, if Bumpers merely eliminated the Reagan administration's authority to give content to relatively meaningless laws. Worse still, however, Bumpers does *not* eliminate that authority —but merely transfers it to federal courts which, at the operative levels, will be dominated by liberal Democrats for the foreseeable future! The result: If a Reagan-appointed FTC reverses earlier action and determines that a particular commercial activity is *not* unlawful, one of the 250 federal judges recently appointed

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by Jimmy Carter will be more readily able to prevent the change. (If and when a Reagan Supreme Court comes into being, it will be able to review only a handful of these cases.)

Item: Magnuson-Moss rulemaking procedures. These procedural requirements convert simple notice-and-comment rulemaking into a proceeding that more closely resembles court litigation—with oral hearings, cross-examination of witnesses, and judicial review under a standard that imposes a higher burden of proof upon the agency. Many "anti-regulatory" legislators favor the extension of these procedures from the FTC (where they now apply) to other agencies. The result: Since existing rules can only be eliminated or amended *by rulemaking,* impositions adopted with facility in earlier years will only be removable with difficulty.

Item: The legislative veto. This device subjects new agency rules to nullification by Congress, without the impediment of presidential veto that accompanies ordinary congressional action. The most popular form of the proposal, the so-called one-house veto, enables either house of Congress acting alone to stop agency rules. Since, as noted above, existing rules can only be changed *by rule,* the net effect in the present Congress is that the Democrat-controlled House will be able to prevent the dismantling of regulatory controls.

Item: Statutory requirements of cost-benefit analysis to justify new rules. Such measures would demand that the benefits to be derived from a new rule match or exceed its anticipated costs, and in some versions would even provide for judicial review of the agency determination. But a rule which merely undoes a preexisting rule has costs and benefits as well—the costs being the forgoing of the previously anticipated benefits, and the benefits being the elimination of previously imposed costs. The result: Unless the statutes are carefully drawn so as to apply only to rules that increase the burdens imposed on the private sector, extant regulation will be accorded a sort of presumptive validity, and the elimination of regulation will be subjected to a burden of proof that the original adoption of regulation never confronted. In some areas, it may be impossible to sustain that burden of proof (especially if it must be sustained to the satisfaction of regulation-prone courts) because of the irremediable absence of hard data —for example, data on the effects that would be produced by competition in a field traditionally committed to government-protected monopoly, or data on the carcinogeneity of certain substances. In other words, for areas already subject to regulation, the cost-benefit statutes that have been proposed in effect adopt the rule: when in doubt, leave it regulated.

Other items might be added. The point is that with the executive branch in control of deregulators the play of forces has been fundamentally reversed. It can no longer be assumed that any impediment to executive action must produce a net gain for the private sector. In fact, that assumption has never been universally correct, as the nuclear power industry learned to its sorrow. Where government action is needed by the private sector, as it is for the licensing of new nuclear plants, the procedural safeguards and judicial-review protections so carefully nurtured in other contexts by the corporate bar have proven to be a Frankenstein—affording licensing opponents unlimited opportunities to impose costly delays. So also, such provisions can be used to frustrate deregulation, sought by the private sector from an executive evidently eager to accord it.

Executive-enfeebling measures such as those discussed above do not specifically deter regulation. What they deter is change. Imposed upon a regulation-prone executive, they will on balance slow the increase of regulation; but imposed upon an executive that is seeking to dissolve the encrusted regulation of past decades, they will impede the dissolution. Regulatory reformers who do not recognize this fact, and who continue to support the unmodified proposals of the past as though the fundamental game had not been altered, will be scoring points for the other team.

Executive-enfeebling measures . . . do not specifically deter regulation. What they deter is change.

Of course not all of the continuing support for such restrictive measures can be attributed to the deregulators' failure to realize that the goal posts have been reversed. There are other potent factors involved. The legislative veto, for example, reflects a basic power struggle between the executive and legislative branches,

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whose causes and effects extend well beyond regulatory policy; and many members of Congress may value the augmentation of legislative power above the regulatory policies narrowly involved, and above party loyalty to a Republican-controlled executive. Moreover, much of what passed for support of deregulation during the last administration was in fact merely opposition to change. Specifically, some of the business support for the measures discussed above sprang from a well-informed desire, not to prevent further regulation, but to impede the elimination of anti-competitive protections that existing regulation affords. Now that the election has altered the game, so that those who are anti-regulation and those who are anti-change are not generally on the same team, we would expect to see a falling-out among prior allies. (When the defections have occurred, by the way, the deregulation forces may be much less numerous than they once appeared.)

But still, I continue to attribute much of the support for executive-enfeebling measures to the philosophy of government (or of non-government) described by the Saxbe Hypothesis—the understandable but nonetheless disastrous aversion of the proponents of limited government to making vigorous use of the legitimate machinery of government to achieve their goals. Their enemy, of course, has no such aversion—so they are an army doomed to attack on foot and retreat by mechanized personnel carrier. This is not to suggest that unbridled executive discretion, during *any* administration, is a good thing; it assuredly is not, and no one has been more enthusiastic than I for legislated *substantive* standards to replace the meaningless generalities of many existing laws. But so long as those generalities continue to exist, then the imposition of new procedural impediments can only succeed, during the Reagan administration, in preserving the administrative decisions of the past. And one can predict that when the wheel comes full circle, and the proponents of government ordering are once more in control, the impediments will be eliminated (as they were, massively, during the New Deal) or evaded (as they have been during the last decade through the imaginative use of rulemaking rather than adjudication to make new law). It is, alas, an unequal struggle, the forces of deregulation, for the time being, battling forward—as they prefer—on foot. ■

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PRICE COMPETITION ON THE NYSE

Jeffrey A. Eisenach
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UNTIL MAY 1975, the brokerage industry was among the most enduring of the world's cartels, having maintained a system of fixed commission rates since 1792. That cartel, existing under the auspices of the New York Stock Exchange (NYSE) with oversight by the Securities and Exchange Commission (SEC), maintained controls on both prices and entry. Prices, in the form of a complex schedule relating the commission charged to the price of the stock and the number of shares being traded, were set by the Board of Governors of the NYSE (elected for the most part by NYSE members) and ratified by the SEC. Membership in the New York Stock Exchange was limited, and new members could join only by purchasing memberships from departing firms and by meeting strict conditions laid down by the exchange.

Then—and now, of course—the NYSE was not the only stock exchange, and not all stock brokers were members. The largest of the competing exchanges was the American Stock Exchange (AMEX); in addition, there were "over-the-counter" markets for stocks not listed on the major exchanges. Brokers that were not members of the NYSE had to execute trades on the exchange through member brokers, at industry-regulated rates.

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Analysts found that the brokerage cartel performed almost exactly as economic theory predicted: Unable to compete directly by offering reduced commissions, brokerage firms competed indirectly by offering a variety of services in addition to the simple execution of stock trades. Research services were the main "frill" offered, but plush "boardrooms," free selling of mutual funds, and indirect rebates known as "give-ups" were also common.

In 1968 the NYSE applied to the SEC for approval to raise its minimum commission schedule. The Department of Justice intervened, however, with a brief that raised the basic question—why was a fixed commission system needed at all? The outcome was a round of hearings and debates that led first to the end of mandatory fixed commissions on very large orders in 1968 and finally to the end of fixed rates altogether in May 1975.

Almost needless to say, the NYSE and its member brokers were adamantly opposed to price deregulation—at least its earliest phases. In 1968 the exchange made its own study of what such deregulation might do to the industry (*Economic Effects of Negotiated Rates on the Brokerage Industry, the Market for Corporate Securities and the Investing Public*). The study predicted that a shift to negotiated rates would lessen incentives for exchange membership, causing NYSE membership to decline. A greater percentage of trades would take place away from the NYSE floor, making it

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more difficult for the SEC to regulate the market. Price deregulation would also lead to cutthroat competition among brokers and increased industry concentration without increases in efficiency. Ancillary services such as market research would be eliminated.

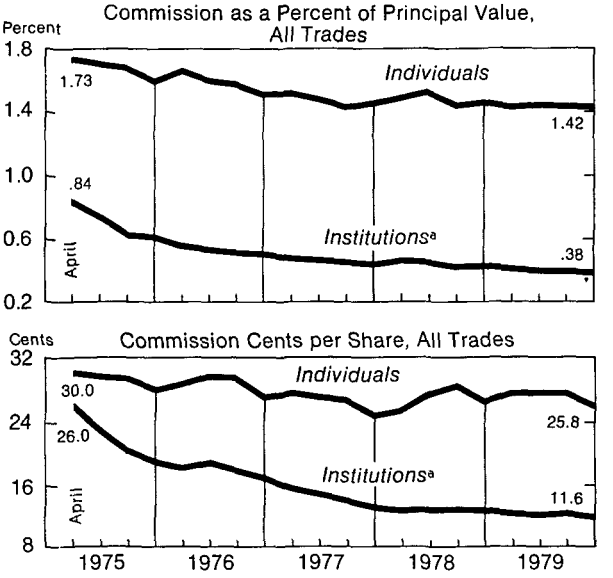
Now more than five years have passed since the SEC ended the fixed commission system, easily enough time to begin to draw conclusions about the results. The studies completed to date, the most comprehensive of which are by the SEC itself, conclude that the deregulation has been successful. Here we analyze its effects on prices, profitability, and industry structure, finding that the market for securities trading in the United States has been improved—for consumers and the securities industry alike.*

Prices

That the fixed-rate system had produced excessive commission levels was evident immediately following the deregulation of commission rates in May 1975. In contrast to the series of commission rate increases that had characterized the late 1960s and early 1970s (the last of which took effect on April 1, 1974), the trend in commissions following deregulation was downward. The SEC's first report on the matter, issued in December 1975, noted that commission rates for institutions fell 26 percent between May and August 1975 when measured as a percent of principal (value of the shares traded), and 19 percent when measured by cents per share. Individual rates fell by lesser proportions—2.3 and 2.0 percent for the respective measures. Rates for all large-lot transactions, both individual and institutional, fell significantly, while commissions on small and odd-lot transactions rose marginally.

The SEC report also examined the effect of price deregulation on brokerage house revenues. The effect was estimated by calculating the amount of revenue that would have accrued to NYSE firms under the old fixed-rate schedule, assuming the same transactions as actually occurred under the new negotiated rates. By that measure, brokerage firms received $89.6 million less in the first *four months* following the deregulation than they would have under the old schedule. So in effect consumers of brokerage services saved nearly $90 million.

Figure 1
EFFECTIVE COMMISSION RATES OF NYSE FIRMS, APRIL 1975 THROUGH 1979



a Where institutional and individual customers cannot be precisely identified, COD business is defined as institutional and all other business as individual.
Source: Securities and Exchange Commission, *Staff Report on the Securities Industry in 1979*, September 1980, p. 46.

Perhaps more important, it is also clear that price freedom allowed brokers to give discounts for low-cost transactions involving large blocks of shares. According to the SEC's *Report on the Securities Industry in 1978:*

> The fixed rate schedule underestimated the fixed cost component and overestimated the variable cost component of the commission business. Abolition of the fixed rate schedule has resulted in a *restructuring of commission rates to bring them in line with actual costs.* [Emphasis added.]

In other words, competitive rates resulted in relatively lower prices for larger transactions. Consumers took advantage of the new rate structure by increasing the size of their transactions. The SEC found that the average individual order rose from 263 shares in April 1975 to 363 in December 1977, while the average institutional order rose from 1,141 shares to 1,572.

The decline in commission levels that characterized the first four months following the

*It should be noted that the 1975 deregulation affected commission rates only. The securities industry and the exchanges are still subject to extensive controls, including margin requirements, stock registration requirements, and a variety of entry limitations.

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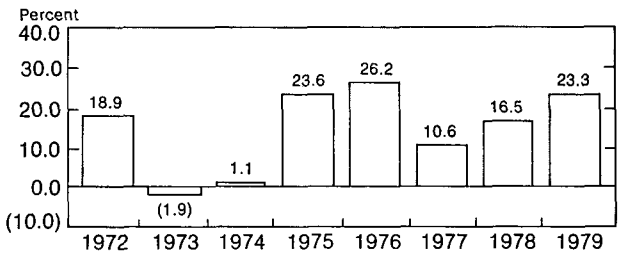
price deregulation continued for nearly three years. As Figure 1 indicates, between May 1975 and December 1977 commission rates for individuals fell 18.3 percent when measured in cents per share and 16.2 percent when measured as a percentage of principal value. By comparison, institutional rates fell 48.8 and 45.9 percent according to the same measures, respectively. The SEC estimated that price competition saved consumers of brokerage services nearly $700 million in the first twenty months following deregulation.

After 1977, commission rates generally leveled off. Looking again at Figure 1, rates charged by NYSE member firms (not adjusted for inflation) fell moderately for institutions and rose slightly for individuals in 1978 and 1979. An SEC analysis of that period showed that the "shaking out" process—the post-deregulation readjustment and search for equilibrium—was completed by 1978 *(Securities Industry in 1978)*. In other words, the market took a little over two years to reach a new equilibrium.

Figure 2

PRE-TAX RETURN ON CAPITAL, NYSE FIRMS DOING A PUBLIC BUSINESS, 1972–79



Note: Return on capital is defined as the ratio of income (after partners' compensation but before taxes) to total capital. Total capital is defined as the sum of ownership equity and subordinated borrowings.
Source: Securities and Exchange Commission, *Staff Report on the Securities Industry in 1979*, p. 39.

Profitability

As shown in Figure 2, NYSE firms operated unprofitably for the two years before deregulation, but turned in healthy profits for the years 1975–79. In the past, the revenues and profitability of the securities industry have been influenced more by the volume of stock trading than by any other single variable. This factor, along with the trend in stock prices (which also has a direct positive impact on industry profits), was largely responsible for the lack of profits in 1973 and 1974, and for high revenues and profitability in 1975 and 1976. In 1977, however, when market conditions deteriorated, industry profitability did not suffer badly. And in 1978, when market volume rebounded, profits did also (though not by comparable proportions, largely because of higher interest rates and hence higher interest expenses to brokerage firms). In 1979, another good year for the stock market generally, profits rose further by 61 percent.

While it is not possible to draw strong conclusions about the effects of deregulating commission rates on profits, it is clear that cost-based prices do not necessarily result in decreased profitability for an industry as a whole. By eliminating "frills," diversifying, and restructuring, the securities industry has been able to earn very high profits even while receiving drastically lower prices for its primary output. The SEC has concluded, moreover, that diversification and pricing freedom have lessened the influence on profitability of cyclical changes in trading volume *(Securities Industry in 1978)*.

Industry Structure

Since 1975 the securities brokerage industry has undergone a substantial restructuring. On balance, however, this appears to have been beneficial.

The most publicized, if not the most important, change of this kind in the last decade has been a substantial increase in industry concentration. In response to general concern about that development, the SEC examined the relevant facts in some detail. It found that the percentage of total industry commissions accounted for by the top ten firms increased from 38.2 percent in the first quarter of 1975 to 45.9 percent in the final quarter of 1978. Concentration as measured by equity capital and other measures increased as well. However, the SEC noted, "the data suggest that the trend toward increased concentration began well before the introduction of negotiated rates in May of 1975. This suggestion, furthermore, is supported by our statistical analysis" *(Securities Industry in 1978)*. So, while the years following the deregulation of commission rates witnessed an increase in concentration, the increase was appar-

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ently not the result of deregulation. Indeed, the rate of increase seemed to slow after 1975.

To further investigate the extent of concentration in the brokerage industry, the SEC compiled lists of the top ten firms (measured by commission income, underwriting income, gross revenue, and equity capital) for each of the years 1972–78. Mobility in and out of the top ten has been extensive, and firms that ranked as low as twenty-sixth in 1972 were in the top ten by 1978.

Some observers argue that increased concentration results from increased returns to scale—that is, larger firms have cost advantages not available to smaller firms and thus are able, over time, to increase their shares of the market. SEC studies indicate that this has not been the case in the securities brokerage industry. Comparing firm profitability and firm size in 1977, 1978, and 1979, the SEC found no significant correlation; in fact, to the extent that any discernible correlation existed, it appeared to be negative *(Securities Industry in 1979)*.

Much of the concern over brokerage industry concentration resulted from the highly publicized increase in mergers that occurred following deregulation. That increase, it appears, was largely a manifestation of the attempts of firms to restructure their operations to meet new market conditions. For example, firms that relied heavily on institutional customers before 1975 found themselves facing vastly different conditions thereafter. Comparing the months before deregulation with 1976, while NYSE firms in the aggregate experienced a fall in average monthly commission revenues of only 1 percent, firms classified by the SEC as "institutional" experienced a 20 percent decline. The SEC concluded that the revenue loss to institutional firms in 1975 and 1976 "caused several small institutional broker-dealers to leave the securities business or to merge with larger retail-oriented broker-dealers" (*The Effect of the Absence of Fixed Rates of Commission*, January 1977).

While the bulk of the industry has diversified into such areas as trading, financial planning, and insurance, so as to become less dependent on commissions, an entire new segment has emerged that depends almost entirely on commission revenue. Before 1975 there were, according to the SEC, only a "handful" of so-called discount brokerage houses, offering brokerage services at below-market rates. Because the rates on the NYSE floor were fixed, these houses traded almost exclusively in over-the-counter stocks. Since 1975, however, discount brokers have become a major force in the industry, either negotiating arrangements with NYSE members to make NYSE transactions for them at a reduced rate or becoming NYSE members themselves. These firms offer a price-quality option not previously available—no-frills service at a low price. Generally, they do business over the telephone, do not offer the research services provided by the "full-line" brokerage houses, and maintain less excess capacity than other firms. According to the latest SEC data, there are now ninety-seven discount brokers, accounting for nearly 8 percent of the total retail market. The SEC has found that the discount brokers consistently outperformed other NYSE member firms in terms of profitability *(Securities Industry in 1979)*.

Conclusions

In summary, price deregulation in the securities brokerage industry has brought lower prices for most classes of service and a greater array of price-quality options, without having significant adverse effects on the industry. It is important to note, however, that these benefits have come about even though the industry is still heavily regulated. For example, entry into the NYSE is still limited. While the price of seats on the NYSE did drop somewhat following the breakup of the price cartel, it has since risen above pre-1975 levels. Moreover, the NYSE's qualification requirements for membership (character, financial standards, and so on) still exist. Nevertheless, the experience of the discount brokers—firms that began as non-NYSE members bargaining for access to the exchange through NYSE member firms—indicates that significant benefits can accrue even in the presence of qualification requirements and limitations on direct access to the market.

Steps towards deregulating prices have now been taken in airlines, communications, railroads, and trucking, as well as in securities brokerage. In each case, advocates of deregulation predicted lower prices for consumers without disastrous effects on industry profits or structure. The example of the securities brokerage industry appears to support those claims. ■

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ELECTRIC UTILITY REGUI NATIONAI POLICY

Peter Navarro

BEFORE THE 1973 Arab oil embargo, electric utility regulation was primarily a distributional affair. Rate-setting disputes reflected a basic conflict over relative income shares between utility shareholders and electrical consumers, with the state public utility commissions (PUCs) acting as arbiters—sometimes impartial, sometimes not. While the quality and distributional results of PUC regulation were notoriously uneven from state to state, there was little spillover into national policy goals. Hence, the federal government found little reason to intrude in a regulatory area traditionally regarded as state turf.

Today, in an era of insecure and expensive energy supplies, unsettled capital markets, and soaring inflation, the stakes in "fair and reasonable" PUC regulation have taken on a new dimension. Such regulation is at the center of this nation's glacial response to reducing the oil import dependence that is draining our real incomes and endangering national security. It is also a ticking time bomb that threatens to explode into rolling brown-outs and power outages in the coming decades. Thus the issue of state PUC regulation—what needs to be done, and how?—is one of increasing importance. In an effort to shed light on that issue, this article examines PUC regulatory failure and its effects on the financial health of the electric utility industry and on the nation's ability to achieve its energy goals.

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Ranking the Regulators

The critical link between state PUC regulation and national energy policy is the impact of "regulatory climate" on the cost and availability of capital to the electric utility industry.

On Wall Street, the concept of regulatory climate has been formalized by a number of investment firms. While there are minor differences among the twenty or so firms that rank the PUCs, each employs a quite similar method to identify the "very favorable," the "favorable," and the "unfavorable" commissions from the viewpoint of the investor. The rankings are based on six objective financial criteria; (1) the allowed rate of return on common stock, (2) the average "regulatory lag" (the time it takes for a PUC to process a rate case), (3) whether a historical or future test year is used, (4) whether construction work-in-progress is allowed in the rate base or, alternatively, whether an allowance for funds used during construction is computed, (5) whether the tax benefits from accelerated depreciation and investment tax credits are "normalized," so that they produce some benefit to the firm, or "flowed through" to the ratepayer, and (6) whether an automatic adjustment clause is in effect.

In general, the higher the rate of return a PUC allows on common stock, the higher a

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malized, the utility's cash flow is larger during the early years of an investment. In contrast, if the tax benefits are flowed through, they do not benefit investors but rather are passed on to consumers in the form of lower rates. Lastly, the use of automatic adjustment clauses (for example, a fuel adjustment clause) allows the utility to pass on cost increases without the delay and expense of a rate hearing—a form of inflation insurance for the utility.

In a quasi-technical manner—no explicit weighting scheme is used by any of the Wall Street rankers—the six objective criteria are combined into a ranking for each PUC. A composite of the 1978 rankings for state PUCs by five investment firms—Goldman Sachs, Salomon Brothers, Valueline, Merrill Lynch, and Duff and Phelps—is presented in the accompanying table.

The policy mix of a PUC such as Indiana's, which has attained a "very favorable" investors' ranking, would typically include most or all of the following: a relatively higher allowed rate of return, CWIP in the rate base, minimal regulatory lag, normalized accounting, use of a future test year, and an automatic fuel adjustment clause. In contrast, the policy mix of a PUC that has attained an "unfavorable" investors' ranking, such as Alabama's, would typically include lower allowed rates of return, AFUDC treatment of construction expenditures, lengthy regulatory lag, flow through accounting, the use of a historical test year, and a partial automatic fuel adjustment clause that

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REGULATORY CLIMATE RANKINGS OF STATE PUBLIC UTILITY COMMISSIONS, 1978

Very Favorable	Favorable	Unfavorable
Arizona	Arkansas	Alabama
Florida	Colorado	California
Hawaii	District of Columbia	Connecticut
Indiana	Idaho	Georgia
New Mexico	Illinois	Iowa
North Carolina	Kansas	Louisiana
Texas	Maryland	Maine
Utah	Michigan	Massachusetts
Wisconsin	Minnesota	Mississippi
	Nevada	Missouri
	New Hampshire	Montana
	New Jersey	North Dakota
	New York	Rhode Island
	Ohio	South Dakota
	Oklahoma	West Virginia
	Oregon	
	Pennsylvania	
	South Carolina	
	Vermont	
	Virginia	
	Washington	
	Wyoming	

only recouped a fraction of the increase in fuel bills.

Regulatory Climate and the Cost of Capital

Recent academic studies have confirmed what the financial community has long known: the more unfavorable the regulatory climate, the higher a utility's cost of capital. The link between regulatory climate and the cost of debt capital is the most direct. Electric utilities typically borrow debt capital in the long-term bond market, and the relative cost of that capital is determined by their bond ratings.

The highest bond ratings are Moody's Aaa and Standard & Poor's AAA, indicating an almost zero probability of default; lower ratings such as Moody's Baa and Standard & Poor's BBB indicate that the utility is developing poor risk and speculative characteristics which make repayment of the debt less certain. In December 1980, the interest rate was 13-3/4 percent on a Aaa bond and 16 on a Baa bond, a difference of over two percentage points. Thus, for the same power plant, a Baa-rated utility like Boston Edison issuing $500 million in bonds to finance a new coal plant would have had to pay interest charges that were over $10 million a year higher than an Aaa-rated utility like Louisville Gas and Electric—charges that would be passed on to the consumer in the form of higher rates over the thirty-year life of the bonds!

Low bond ratings not only imply a higher cost of capital but also reduce the availability of capital. For example, the "prudent man" rule of the Securities and Exchange Commission prohibits many large institutional investors—commercial banks, local pension funds, life insurance companies—from investing in bonds rated below Baa or BBB. That severely shrinks the pool of potential utility investors, and the resultant drop in demand depresses bond prices and forces up interest rates.

In an econometric study, George Pinches, Clay Singleton, and Ali Jahankhani (1978) found that an unfavorable regulatory climate was a major factor explaining low bond ratings. Similarly, Stephen Archer and George Atkinson (1979) examined the link between bond prices and regulatory climate and concluded that the more unfavorable or "rate suppressive a state commission is, the higher the capital costs are to electric utilities operating in that state." Casual empiricism confirms this statistical finding. At present, 90 percent of the utilities with Standard & Poor's ratings of A to BBB are in jurisdictions with an "unfavorable" or "favorable" regulatory climate, while only 13 percent of the utilities with higher quality AAA or AA ratings are regulated by PUCs ranked "unfavorable."

Regulatory climate also appears to influence the cost and availability of equity capital, which is raised through the sale of new common stock. One measure of the cost of equity capital is the utility's M/B ratio, the ratio of the market price of a utility's common stock to its book value (where book value equals the total equity shown on the company's books divided by total shares of common stock outstanding). In general, the lower the M/B ratio, the higher the cost of equity capital.

To illustrate this relationship and the effect of regulatory climate on M/B ratios, Robert Trout (1979) used a composite of the regulatory rankings from four investment and re-

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search groups in a regression model and found that the ratio falls as regulatory climate becomes less favorable. According to Trout, the change from a very favorable to an unfavorable PUC ranking causes the cost of equity capital to rise by almost two percentage points, roughly equal to the effect of regulatory climate on the cost of debt capital. Again, casual empiricism supports these findings. For example, the average M/B ratio for electric utilities in PUC jurisdictions ranked very favorable was .95 in 1978, thirteen percentage points above the average ratio for utilities in unfavorable jurisdictions.

In addition to raising its cost, a low M/B ratio can also reduce the availability of equity capital. In particular, when the ratio falls below one, any new issue of common stock implies a devaluing or "dilution" of the shares of existing shareholders. Dilution occurs because the returns on the investment undertaken with the proceeds from the sale of new stock are not sufficient to maintain the utility's earnings per share at the level before issuance of the new stock. It is therefore not surprising that, when M/B ratios are low, one major source of opposition to raising equity capital is management, for it has the responsibility of protecting the interests of existing shareholders. In his 1979 annual report to shareholders, Northeast Utility's Chairman and Chief Executive Officer Lelan F. Sillin described how a low M/B ratio had affected his company's expansion plans.

> Since late 1974, Northeast has had to sell 16 million shares through public offerings at an average of 34 percent below book value. As a result, we have drastically curtailed our construction program and have not publicly offered any common shares since 1976.

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In summary, recent studies have established a strong link between the worsening financial condition of many electric utilities and the regulatory climate in the jurisdictions in which they operate. The cost of both debt and equity capital appears to rise and its availability to fall as regulatory climate grows more unfavorable.

The Effects of PUC Regulation on National Energy Policy and Ratepayers

What are the implications of such consequences? First, for national energy policy, efforts to reduce foreign petroleum dependence and encourage the use of abundant domestic energy resources are seriously impaired. Second, while the policies that create an unfavorable climate may benefit the ratepayer in the short run, they will force rates to higher levels in the long run and cause service to be less reliable.

National Energy Policy. The electric utility industry currently consumes the energy equivalent of 3 million barrels per day of petroleum.[1] That represents roughly one-third of total U.S. petroleum imports. According to analyses prepared within and for the Department of Energy (DOE), there are two major ways to cut that consumption by over half in this decade.

First, the reconversion of 107 previously coal-capable oil-burning power plants to coal would displace 400,000 barrels of oil a day at a cost of $6 billion. Second, the early retirement of existing petroleum power plants and their replacement by new coal, nuclear, hydro, and other types of plants would further reduce petroleum use by 600,000 barrels a day at a cost of $33 billion. (While retiring usable plants may seem extravagant, DOE analyses indicate that at a world oil price of $30 a barrel over half of present oil- and gas-fired base-load capacity—as distinguished from intermediate and peak-load capacity—is economically obsolete. That is, the combined capital and fuel costs of a new coal or nuclear plant are less than the cost of operating an existing petroleum-fired plant.) Thus, the total capital costs of

[1] Some of this consumption is natural gas rather than oil, but the two can be considered import substitutes because natural gas that is displaced from utility boilers can serve to displace oil from other sectors, thus indirectly reducing imports.

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displacing 1 million barrels of foreign oil a day adds roughly $39 billion to the $533 billion the utility sector must spend just to meet increased electricity demand over the next decade. Should an increase in the cost of capital and a reduction in its availability prevent a portion of this massive sum from being raised, the supplemental investments in petroleum displacement would no doubt be cut back first, despite their favorable economics. Scheduled coal conversions would probably be cancelled and new plant construction would be deferred rather than accelerated.

Because of its weak financial position, the industry seems to be charting precisely such a course. Despite intense federal pressure, less than one-third of feasible capacity has been converted to coal since the 1973 oil embargo. To a certain extent, this dismal track record is traceable to federal and state regulations that have reduced conversion incentives. The primary villain has been federal price controls on oil and natural gas, which substantially reduced coal's competitiveness through most of the 1970s. Today, however, with phased price decontrol under way and oil costing over $30 a barrel and with many PUCs restructuring their fuel adjustment clauses to allow only partial recovery of price hikes, the economics of coal conversion are unquestionably favorable. Nonetheless, the financially strapped utilities remain reluctant to convert and the reason they most commonly cite is that they cannot afford to allocate scarce capital to investment "not essential to keeping the lights on."

The record on the displacement of foreign oil through accelerated construction of new plants is equally dismal. According to the National Electric Reliability Council, over half of the coal and nuclear plant capacity scheduled for 1979 through 1988 was delayed in 1979. Depending on numerous assumptions related to future demand growth, these delays could translate into an increase of up to 2.2 billion barrels of petroleum consumed during that period.

Effects on Ratepayers. National energy policy is not, however, the only victim of an unfavorable regulatory climate. Indeed, while PUC policies that seem to favor consumers do indeed reduce rates in the short run, the longer-run effects are equally clear.

First, as noted, electric utilities face a higher cost of capital in PUC jurisdictions where the regulatory climate is unfavorable. Thus, new construction undertaken in these jurisdictions is more expensive than it otherwise would be and these higher capital costs are reflected in higher long-run rates. For example, if a typical class A utility (say, Commonwealth Edison) is financing $1 billion in new plant capacity, a two percentage point increase in its cost of capital will amount to a rate increase of $20 million a year for the next thirty years—well into the next century.

Second, the deferral of new power-plant construction and coal-conversion investment also has unfavorable consumer effects. For one thing, it means that existing petroleum plants will continue to be operated at high capacity levels. And, since it is now generally more expensive to operate petroleum plants than to build new coal plants or convert, this means in turn that the consumer's electricity rates are not being minimized. In addition, construction deferrals raise the specter of power outages and rolling brown-outs. Consumers will either suffer a reduction in the electrical system's reliability or, more likely, if power shortages emerge there will be a rush to construct less capital-intensive but ultimately more expensive oil-fired combustion turbines, which can be built in under two years. (This would, of course, extend U.S. dependence on foreign oil further into the future.) Lastly, the failure to complete coal and nuclear plants now under construction without delay exposes ratepayers (as well as the nation) to an unnecessary risk: if another Arab oil embargo occurs, if war in the Middle East (for example, the Iranian-Iraqui conflict) closes the Strait of Hormuz, or if some natural or man-made disaster sharply reduces the importation of petroleum into the United States, the utilities will not have the backup capacity to use other fuels. The result will be power outages, reduced industrial activity, unemployment, and hardship.

What Determines the Regulatory Climate?

If both ratepayers and national energy policy goals would benefit from a better regulatory climate, the obvious next question is how to achieve that result. To find the answer, I un-

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dertook an econometric investigation for the Department of Energy in which I attempted to identify and measure the major factors accounting for the marked differences in regulatory climate among the states.[2] On the basis of a review of the literature on regulatory agencies and extensive interviews with PUC staff and commissioners, utility executives, state legislators, and federal energy officials, I identified three groups of variables—political, institutional, and ideological—that could be tested as determinants of regulatory climate.

The *political* variables selected measure the degree of political pressure to which a PUC is exposed. The underlying hypothesis, rooted in the capture theories of regulation of George Stigler (1971) and Sam Peltzman (1976), is that the more exposed a PUC is to political pressure, the less likely it is to adopt the judicial role of arbitrating between consumer and utility interests and, in today's "era of the consumer," the more likely it is to adopt the prosecutorial role of championing ratepayer interests. Political pressure was assumed to increase (and the regulatory climate to deteriorate) when commissioners are elected rather than appointed, when commissioners' terms are relatively short, when PUCs are funded by tax dollars from general revenue funds rather than through assessments on utilities, and as the percentage of oil used by a utility to generate power increases. (In states with heavy oil use and a fuel adjustment clause, ratepayers have been subjected to rapid and highly visible rate increases in the form of "fuel surcharges." This was assumed to heighten both ratepayer response and political pressure.)

The *institutional* variables measure the degree of administrative and professional competence that a PUC is likely to exhibit. The underlying hypothesis, grounded in the behavioral models of regulatory agencies of William Niskanen (1971), Paul Joskow (1974), and Roger Noll (1975), is that a well-staffed, well-trained, and well-equipped PUC is more likely to process rate-of-return requests in a timely and equitable fashion than an understaffed, poorly organized, or poorly equipped PUC. Regulatory climate was expected to improve with higher salaries, higher expenditure levels (up to a point), and a statute requiring that commissioners be professionally competent to perform their jobs. Salary level reflects the ability of a PUC to compete for qualified staff and commissioners, while expenditures are a proxy for the resources available for the prompt processing of rate cases.

The *ideological* variable measures the influence of liberal, "pro-consumer" ideology versus conservative "pro-business" ideology on the policies adopted by PUCs. The underlying hypothesis, rooted in the ideological models of policy formulation developed by Edward Mitchell (1977) and Joseph Kalt (1978), is that a "liberal" state is more likely than a conservative state to use a PUC to effect income redistribution for the benefit of traditionally favored groups such as consumers. It was assumed that a Democratic party affiliation indicates a more liberal ideology and that the regulatory climate would worsen as the percentage of Democratic commissioners on a PUC increased.

Using the PUC rankings in the table as the dependent variable, a procedure similar to regression analysis (a multinomial logit statistical procedure) was used to test the impact of these political, institutional, and ideological variables on regulatory climate. The results were overwhelmingly conclusive. PUCs with directly elected commissions were found to be the most likely to have an unfavorable regulatory climate, holding all other variables constant. Specifically, for an "otherwise average PUC" (based on the sample mean), a shift from an appointed to an elected commission increased the probability of an unfavorable rank by forty-eight points (from .14 to .62). Similarly, a shift to a salary level 15 percent below the mean caused the probability of an unfavorable rank to jump twenty-five points. PUCs with be-

The results were overwhelmingly conclusive. . . . PUCs with below average expenditure levels, a heavy reliance on general revenue funding, short commissioner terms, and a high percentage of Democratic commissioners [tend] to generate an unfavorable regulatory climate. . . .

[2] For details, see Discussion Paper E-80-05, "Public Utility Commission Regulation: Performance, Determinants, and Energy Policy Impacts," Harvard University Energy and Environmental Policy Center, October 1980.

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low average expenditure levels, a heavy reliance on general revenue funding, short commissioner terms, and a high percentage of Democratic commissioners were also much more likely to generate an unfavorable regulatory climate than PUCs with the opposite characteristics. For example, a shift from assessment funding to general revenue funding for the "otherwise average PUC" increased the probability of an unfavorable rank by forty points (from .08 to .48), while a shift from a PUC having no Democrats to one having all Democrats increased the probability of an unfavorable rank seven points. Finally, a requirement that commissioners be professionally qualified and a reduction in the percentage of oil used by utilities in states having automatic fuel adjustment clauses appear to improve regulatory climate, although the effects appear weaker.

Policy Responses to the PUC Problem

It is perhaps easier to determine the effects of PUC regulation on national energy policy and ratepayers than to decide what the policy response ought to be. Federal intervention risks usurping states' rights. On the other hand, a failure to act means a missed opportunity to displace up to 2.6 billion barrels of oil over the next decade. Recognition of these problems suggests a two-phase solution: short-run federal intervention combined with long-run regulatory reform undertaken by the states or, failing that, imposed from Washington.

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Short-Run Federal Intervention. Short-run displacement of petroleum imports will probably require some type of federal aid since regulatory reform is unlikely to come about quickly enough to solve the utilities' financial problems. One form of assistance might be a government grant program for petroleum-displacing investment. For example, the Carter administration's proposed "utility oil back-out" bill, whose goal was a 1 million barrel a day reduction in petroleum consumption by 1990, would have provided roughly $10 billion in funds for coal conversion and petroleum-displacing investments in coal, solar, nuclear, and other nonpetroleum technologies. That bill, which was defeated in the last Congress, was opposed mainly on the ground that it represented a Chrysler-style bail out of the utility industry and its regulators. To members of Congress like Richard C. Shelby (Democrat, Alabama), large-scale federal aid was a perverse reward for utility mismanagement and the wrong solution to the more fundamental problem of PUC misregulation. Shelby's point is well taken. In my view, however, there is great risk in not seizing the opportunity to displace 1 million barrels of petroleum a day by 1990.

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In the longer run, regulatory reform is clearly preferable to federal aid. The difficult question is whether the federal government should rely on the states for reform—at the risk it will never be done—or impose it directly—at the risk of violating states' rights.

Federal Regulatory Reform. The three commonly mentioned federal remedies for the PUC problem are nationalization of the regulatory apparatus, regionalization of the PUCs, or the imposition of federal regulatory standards.

Nationalizing regulation, whereby the federal government takes over the responsibility of regulating the utilities from the PUCs, might be more useful as a threat to force state regulatory reform than a workable solution. The most likely agency to assume state regulatory responsibilities would be the Federal Energy Regulatory Administration (FERC), which regulates the wholesale sales of electric power. But FERC has neither the staff nor the resources to handle such massive new responsibilities. Besides, having only an average regulatory climate ranking itself, it is perhaps not the model agency for such a challenge. Under its steward-

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ship, regulatory performance might improve in states like Mississippi, Missouri, and Georgia, but deteriorate in Texas, Indiana, and North Carolina.

Regionalizing electric utility regulation might be a more useful approach. At present, state PUCs rarely communicate or coordinate with one another. Most utilities, however, provide electricity on an interstate basis and many are organized into sophisticated regional power pools that help minimize the costs of electricity through the sharing of power. Perhaps the most likely method of bringing regionalization about would be for Congress either to mandate that states organize regional regulatory commissions or, alternatively, to create them itself (with state representation being achieved by allowing the states to appoint their own commissioners). This would preserve a degree of state control over state-based utilities, while creating a structure that more closely parallels that of the national electrical generation and delivery system. Regional coordination also would provide a system better equipped to cope with the kinds of energy shortages that stemmed from the oil embargo of 1973 and the 109-day coal strike of 1978.

A *federal standards* approach would involve promulgating new regulatory requirements that the PUCs must adopt. Such standards should include those policies that will improve regulatory climate: allowing CWIP in the rate base, normalizing tax benefits, using a future test year to calculate rates, and limiting regulatory lag (for example, by allowing, as Massachusetts has done, a maximum of six months for consideration of rate hikes). The precedent for a federal guidelines approach already exists in the Public Utility Reform and Policy Act of 1978, which set up five rate-making and six regulatory standards for state PUCs.

State Regulatory Reform. If states want to avoid federal intervention, then regulatory reform must come from within. For the PUCs, that means (once again) shifting to the innovative policies that produce a healthy regulatory climate. This course is not without political hazards, however, for any diminution in existing "consumerist" policies will be hard fought.

Thus state legislative action will also be needed—to depoliticize the PUC environment as well as to improve the quality of PUC regulation. Most of the required reforms are obvious. To reduce politicization, PUC commissioners should be appointed rather than elected, their terms should be long enough to insulate them from political pressure, and the PUCs themselves should be financed primarily through assessments on the utilities rather than from general tax revenues. To improve the quality of regulation, salaries should be competitive with those for similar federal and industry positions, professional competence should be required of commissioners, and the PUCs should command budgets adequate to the responsibilities they face.

The policy response to the finding that a state's regulatory climate worsens with increased oil use by utilities is less clear. Nevertheless, because there are economic and national security costs associated with petroleum import dependence and because poor regulatory climate contributes to that dependence, federal aid to assist the petroleum-dependent states in reducing their consumption seems justified.

Finally, the glib response to the finding that regulatory climate worsens as the percentage of Democrats on a PUC increases is "throw the rascals out." The more serious message, however—and one that was perhaps transmitted in the last election—is that it is time to rethink some basic liberal doctrines. In the field of electric utility regulation, enlightened policy requires not only bucking the tide of public opinion but also turning it around. For, in the long run, "pro-consumer" policies raise rates, reduce the electrical system's reliability, and worsen our oil import dependence. Regulatory reform would allow the nation's utilities to earn a fair and reasonable return and everyone would be better off—everyone, that is, except OPEC. ■

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Taming the Paperwork Tiger

An Experiment in Regulatory Management

Richard M. Neustadt

LAST DECEMBER a wan President Carter entered the Cabinet Room to sign one of his final legislative achievements—the Paperwork Reduction Act of 1980. The ceremony received about as much press coverage as the latest Bulgarian soccer scores. But in the bureacracy it was a milestone. In fact, representatives of five cabinet departments had worked long into the previous night trying to get the President to veto the bill.

This law capped a four-year effort to cut the amount of paperwork the federal government imposes on state and local government and the private sector. The result of that effort is elaborate and innovative machinery for "paperwork budgeting," a device designed to control delegated power. While the law is brand new, major parts of the machinery were put in place by administrative action in November 1979. Based on experience so far, they seem to be doing the job.

The paperwork story offers lessons for the rest of regulatory reform. Even as Congress was passing the Paperwork Reduction Act, it was dismembering Carter's main regulatory reform bill (S. 755) in a vicious turf war. To the question—"Who regulates the regulators?"—contending factions gave different answers: many lawyers said "the courts" (through tough judicial review); lobbyists said "the Congress" (through the legislative veto); Carter administration officials said "the White House" (through tighter management); and regulatory enthusiasts said "the regulatory agencies themselves." In the paperwork context, the same question was quickly settled the way the Constitution intended: through clear guidelines to the agencies and strong oversight from the White House.

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The Paperwork Problem

Apart from the lessons it offers, paperwork reduction matters for its own sake. According to a national commission, federal paperwork costs up to $100 billion a year. The Office of Management and Budget (OMB) uses a more reliable measure of the burden: it multiplies the time required to gather information and fill out each form by the number of respondents. OMB figures that in 1981 Americans will spend over 1.2 billion hours filling out 5,000 federal forms. Whatever time is worth, that adds up to a lot of money.

Almost all these forms are either compulsory or are prerequisites for obtaining grants or contracts. Tax forms account for about half the total. Another major source is the recordkeeping required by regulatory programs, such as the logs truckers must file with the Transportation Department and the records handlers of hazardous substances must file with the Environmental Protection Agency (EPA). Most forms are designed by low-level officials who focus on their own program needs and give little thought to cumulative burden or overlap with other programs. And because the great bulk of the cost of information collection is borne by the respondents, agencies are wont to collect more than they really need.

Washington first tried to control the paperwork load with the 1942 Federal Reports Act. That act directed agencies to obtain clearance from OMB for any form aimed at ten or more respondents and authorized OMB to veto a form or order it changed. In recent years, a staff of a dozen working on the management

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side of OMB had the joyless task of weeding out unneeded, duplicative, or overly burdensome items. This group faced huge handicaps:

- The Federal Reports Act exempted tax forms and (as amended in 1973) the forms required by the independent regulatory commissions. (The 1973 amendment was adopted when OMB tried to use its clearance power to hold up the Federal Trade Commission's controversial "line-of-business reports" study.) Those two loopholes represented 55 percent of the total paperwork burden.
- The act often was ignored, and OMB lacked the resources even to identify violators, let alone bring them to heel. Thus, for more than a decade the Department of Health, Education, and Welfare (HEW) had required states to prepare several detailed annual plans for welfare programs without ever having submitted the forms for clearance.
- Form-by-form clearance was a losing game. OMB's little team of generalists was pitted against a horde of program managers who could give elaborate reasons why each part of each form was essential to good government. The routine of processing a torrent of paper made it hard for OMB to focus on the big items. And when OMB staffers did reject or delay a form, agency officials appealed to OMB's leaders, who had little appetite for arbitrating a string of relatively trivial paperwork squabbles.

In the mid-1970s, when the public mood turned against big government, the mounting paperwork burden was one of the targets. News stories and constituent complaints led members of Congress to demand action, but since no one was sure what to do, Congress took the usual course. In 1975 it created the Commission on Federal Paperwork. About the same time President Ford, facing an election campaign, ordered his department heads to cut the number of reports by 10 percent at a stroke. The action backfired. Agencies simply combined two or three reports into one, so the number of reports went down, but the burden went up.

President Carter arrived on the scene in January 1977, having spent two years on the hustings promising to slice red tape. At his first Cabinet meeting he directed his department heads to deliver on those promises. Later that year the report of the Commission on Federal Paperwork proposed hundreds of individual cuts that the agencies could not ignore. Cabinet members told assistant secretaries to produce results and, for the first time, program officers' decisions about forms were reviewed at a department-wide level. OMB, changing its focus from numbers of forms to numbers of hours, used the paperwork commission's recommendation and its own long experience to develop a hit list. The man who ran the process, OMB Deputy Assistant Director Louis Kincannon, put it this way: "We'd been watching those forms for years and knew where to cut. The agencies knew President Carter would back us up, so we were finally able to get their attention."

For a time, this effort paid off. The Labor Department cut reporting on pension plans by 1.4 million hours by deleting the requirement that an entire new description be filed each time a pension plan was amended. The Occupational Safety and Health Administration dropped reporting requirements for 40,000 small businesses with good safety records. The Internal Revenue Service (IRS) cut its "short form" tax return by a third. Government-wide, the paperwork burden fell 15 percent in two years.

In 1979, however, progress ground to a halt. OMB was running out of easy targets, and huge new reporting requirements loomed ahead, especially from environmental and energy regulations. More fundamentally, the program had encountered the classic nemesis of regulatory reform: the superior staying power of the bureaucracy. President Carter and his department heads naturally were distracted by more urgent problems. OMB's little team was bogged down in the process of clearing thousands of forms. As pressure from above abated, assistant secretaries—who face endless struggles with program managers over money, personnel, legislative priorities, and so on—found it easy to forget about paperwork. And the program managers had the same old incentives to collect all the information they could. Thus, White House planners faced the dreary prospect of a rising paperwork burden in 1980—not a helpful footnote for a campaign position paper.

The 1979 Program

Clearly, new machinery was needed to strengthen OMB's hand and make the agencies do more of the work. The plan that was developed by a half dozen staffers from OMB, the White House, and Capitol Hill reflected the paperwork com-

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mission's recommendations and the 1977–79 experience. As announced by President Carter in November 1979, the plan had eight parts:

- *A paperwork budget.* This scheme, officially named the "Information Collection Budget," was designed to work like the spending budget, except that OMB—not Congress—would make the final decisions. Every summer, the agencies would list for OMB all the forms they expected to use in the following fiscal year, estimating the time burden for each. After OMB "budget hearings" at which agency officials would defend their requests, OMB would make cuts—which the agencies could appeal to OMB's director or, in theory, to the President. The final budget would prescribe burden ceilings for each agency and mandate cutting back or eliminating individual forms. New forms could not be added without OMB permission.
- *Oversight offices.* Each department and agency would designate a unit to run paperwork control, while OMB would create a new high-level office to handle the paperwork budget and enforcement of Executive Order 12044 (Carter's regulatory management program).
- *An information locator.* OMB would set up a computerized listing of all the types of information the government collects. Before a new form could be approved, its author would have to check to see if another agency was already collecting the information.
- *Sunset.* Each form would terminate in three years unless resubmitted to OMB.
- *Sharing.* If two agencies wanted similar data, OMB would designate one of them to do the collecting for both.
- *Closed loopholes.* OMB's authority over paperwork would be extended to cover the IRS and the independent commissions.
- *Delegation.* OMB would be permitted to delegate the routine clearance job to agencies that had established effective internal controls. This would allow OMB's small staff to concentrate on the most productive work and give agencies incentives to discipline themselves.
- *Enforcement.* To underscore OMB's authority, agencies would be forbidden from taking action against persons who failed to fill out a form not submitted for clearance.

Legislation was needed to put the last four items into effect as well as to apply the first four to the independent commissions. But the paperwork budget was the heart of the program, and the President was able to launch that immediately. He did so in an executive order of November 1979 that also created the oversight offices, the information locator, and the sunset process. Let us first examine the progress made under the machinery established by this executive order and then return to the legislative front.

The Paperwork Budget

Initially, the bureaucracy paid little attention to the new procedures, but in mid-1980, when the agencies had to prepare their budget submissions, there was a tidal wave of protest. Some departments discovered they did not even have lists of all the forms they had issued. And some program officers, who suddenly had to predict paperwork requirements in advance, protested that there was no way of knowing the length of forms not yet written or of anticipating all the information needs that might arise. They claimed that it was unreasonable to evaluate all forms by the same standard—hours required to fill them out—when some provide much more valuable information than others. They contended that the budget process was itself a huge paperwork machine which would disrupt program operations. The most passionate complaints came from IRS and some of the regulators, who argued that the budget would let OMB's career civil servants control substantive decisions.

Several cabinet members urged that the paperwork budget be killed, but the President and OMB Director McIntyre stuck to their guns. Once it was clear that the budget was inescapable, most agencies tried in good faith to make it work. After all, officials in the agency oversight offices now had career incentives to cut paperwork and in any case could not delegate to program managers a task that involved making trade-offs among programs.

Some of the payoffs were immediate. The budget-compiling process flushed out hundreds of forms that had never been reported, including HEW's welfare planning forms. Overall, an astounding 188 million hours of paperwork was discovered. Moreover, because the process forced administrators to take a hard look at each form for each program, many of them came up with their own ideas for reductions. For example, the Agriculture Department decided it could collect data on the demographic

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breakdown of school lunch recipients annually instead of monthly, thereby saving the nation's schools about 9 million hours of paperwork. Equally important, OMB, in a position at long last to look beyond the myopic clearance process, found broad areas for cuts. When it noticed, for example, that those newly discovered welfare forms forced states to put identical information into several plans, it simply cut the whole category by an arbitrary 10 percent. That compelled the program people to get together—for the first time—and develop a consolidated report. OMB also cut the Department of Education's budget by ordering that some data be collected by sampling. And it suspended nine agencies' surveys on the uses of public lands pending the development of a uniform questionnaire by the Interior Department.

The White House announced the final budget figures in January 1981. From a fiscal 1980 base of 1,276 million hours of reporting (including the newly discovered forms), the agencies had requested a net increase of 8 million. OMB's cuts yielded a final budget of 1,228 million—for a saving of 56 million hours.

In evaluating paperwork budgeting, the first question is whether these numbers mean anything. The estimates necessarily come from the same program officers who design the forms; and the best and most commonly used approach is to quiz a sample of the respondents on how much time they spent filling out the forms. This approach leaves the door open to error and cheating. OMB maintains, however, that its numbers for the fiscal 1981 paperwork budget are fairly good. Burden estimates have been required as part of the clearance process for years, and OMB's spot checks showed that the figures submitted by the agencies this time were consistent with earlier ones. While some agencies did consider trying to escape OMB's scrutiny by underestimating the burden caused by new forms, apparently few did so—presumably fearing that if OMB spotted inconsistencies, it would force the guilty agency into a difficult squeeze by raising the number of hours counted as "spent" without raising the ceiling.

Forms not yet designed pose another estimation problem. For example, the Environmental Protection Agency submitted only a rough estimate for its new Toxic Substances Control Act rules and did not even make a guess for the then-pending "super fund" legislation. These kinds of problems will require budget adjustments throughout 1981 as forms are written and submitted for clearance—a process similar to the supplemental appropriations and recisions needed to keep the spending budget up-to-date.

In any event, and perhaps fortunately, success does not depend on perfect accuracy. The real size of the paperwork burden matters less than whether the trend is up or down—and, in this case, the trend is relatively easy to determine. When OMB orders a form revised or killed, it can easily verify that the action has been taken, even if there may be doubt about the exact amount of time saved. OMB's Kincannon is convinced that the fiscal 1981 process yielded enough of those cuts to turn an expected paperwork increase into a modest decline.

The second major question about the budget is whether it is worth the amount of effort it requires. The first year's experience suggests reason for optimism. OMB was able to handle the new system without adding personnel. Its paperwork staff simply spent less time clearing forms and more on strategic decisions, and its top officials did their job of hearing appeals in the late summer when the pace at OMB is relatively calm. At the agencies the load was a bit heavier because the budget demanded attention from senior administrators and program managers, plus full-time work by a few assistants. Thus there were complaints about having to do all this new work without being given additional people or funds—a reasonable gripe. On the other hand, the system strengthened agency administrators vis-à-vis their program managers—just as it strengthened OMB. By the end of the process, views in the bureaucracy were mixed. Most program managers still resented the budget because of the time it took and the external control it imposed. Some department administrators—at Labor, for example—shared that view. Others—at Health and Human Services, for example—found the budget useful in their efforts to impose central management on far-flung bureaucratic fiefdoms.

Meanwhile, on Capitol Hill . . .

As noted, although a great deal could be accomplished by executive order, some important features of the paperwork program required legislation. In November 1979, a paperwork

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reduction bill containing these reforms was introduced by Senator Lawton Chiles and Representatives Jack Brooks and Frank Horton. To spice up the package, the sponsors had added provisions that paperwork be cut 25 percent in three years, that the OMB oversight office be renamed the Office of Information and Regulatory Affairs, and that its mandate be broadened from paperwork and regulatory reform to cover information policy issues such as privacy, statistics, and the procurement and use of computers and telecommunications systems.

At first the bill's progress was rapid, as its proponents easily resolved problems that had stymied other regulatory reform bills:

- The advocates of subjecting new agency regulations to a legislative veto could logically have extended their campaign to paperwork. But the paperwork bill's sponsors had no interest in drowning themselves in forms, and no one else suggested the idea.
- The independent regulatory commissions argued that submitting their forms to OMB for clearance would threaten their sacred freedom from the White House. The compromise was to let a majority of the commissioners themselves override any OMB veto. As a practical matter this is good enough: if an OMB veto is reasonable, commissioners are more likely to revise the form than to vote publicly to insist on it. (Although the new law does not cover the paperwork budget, OMB can use this veto provision and public pressure to rope the independent commissions into the process.)
- Perhaps because few lawyers were lobbying on this bill, there was no effort to require judicial review of paperwork.

The political appeal of paperwork reduction may have accounted for the bill's easy sailing through those waters. Perhaps few saw at the time the link between regulatory enforcement and information-gathering. The bill passed the House without debate. But by midsummer when the Senate was ready to act, there were problems. Regulators, shocked by their first close encounter with the budget, saw that the legislation would strengthen OMB's leverage. And the Defense Department objected to the provision giving OMB control over computers and telecommunications systems.

To avoid a floor fight over paperwork (of all things!) there were negotiations and compromises. Supporters of regulation won a provision saying OMB's authority over substantive policy would not increase and another requiring procedures for public comment when OMB objects to paperwork requirements in a proposed rule. (As a practical matter, these restrictions make OMB's job more burdensome but should not diminish its broad new powers.) And the Defense Department got a provision exempting military and intelligence equipment from OMB's reach.

All this took time. Then in late November, just when the bill seemed dead for the year, Brooks and Chiles arranged for it to be quietly revived and passed. Opponents, caught off guard, sought a presidential veto. The Defense Department was not satisfied with its amendment because some of its systems arguably are not "military." Treasury claimed that OMB clearance of IRS forms would disrupt and perhaps politicize the tax system. Labor and EPA said that OMB's new powers would hamper their ability to manage their programs.

But President Carter rejected these arguments and signed the bill. In the Cabinet Room ceremony he proclaimed, "We've addressed the bureaucrats and we've won."

For a White House determined to cut paperwork, the new arrangement is ideal. It gives the executive important new tools to influence regulatory policy, without using the President's time or embroiling him in controversy. After decades of erosion in presidential authority over the independent regulatory commissions, it takes a first small step in the opposite direction. And it allows OMB to focus on the most important decisions and leave time-consuming implementation to the agencies. But OMB cannot possibly find the right balance between program needs and public burdens for 5,000 forms. Thus, the biggest test will be what happens at the agencies. If the program institutionalizes bureaucratic self-control, it will be a success.

Paperwork reduction is what newspaper editors call a "three-bowler." (It has so little sex appeal that a reader's face will plop into his cereal bowl three times before he finishes the story in the morning newspaper.) That may be one reason why paperwork legislation got farther than the administration's regulatory reform bill. In any case, all the tools are finally in place, and a fascinating experiment in government management is under way. ■

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Cost-Benefit Analysis
An Ethical Critique

Steven Kelman

AT THE BROADEST and vaguest level, cost-benefit analysis may be regarded simply as systematic thinking about decision-making. Who can oppose, economists sometimes ask, efforts to think in a systematic way about the consequences of different courses of action? The alternative, it would appear, is unexamined decision-making. But defining cost-benefit analysis so simply leaves it with few implications for actual regulatory decision-making. Presumably, therefore, those who urge regulators to make greater use of the technique have a more extensive prescription in mind. I assume here that their prescription includes the following views:

(1) There exists a strong presumption that an act should not be undertaken unless its benefits outweigh its costs.

(2) In order to determine whether benefits outweigh costs, it is desirable to attempt to express all benefits and costs in a common scale or denominator, so that they can be compared with each other, even when some benefits and costs are not traded on markets and hence have no established dollar values.

(3) Getting decision-makers to make more use of cost-benefit techniques is important enough to warrant both the expense required to gather the data for improved cost-benefit estimation and the political efforts needed to give the activity higher priority compared to other activities, also valuable in and of themselves.

My focus is on cost-benefit analysis as applied to environmental, safety, and health regulation. In that context, I examine each of the above propositions from the perspective of formal ethical theory, that is, the study of what actions it is morally right to undertake. My conclusions are:

(1) In areas of environmental, safety, and health regulation, there may be many instances where a certain decision might be right even though its benefits do not outweigh its costs.

(2) There are good reasons to oppose efforts to put dollar values on non-marketed benefits and costs.

(3) Given the relative frequency of occasions in the areas of environmental, safety, and health regulation where one would not wish to use a benefits-outweigh-costs test as a decision rule, and given the reasons to oppose the monetizing of non-marketed benefits or costs that is a prerequisite for cost-benefit analysis, it is not justifiable to devote major resources to the generation of data for cost-benefit calculations or to undertake efforts to "spread the gospel" of cost-benefit analysis further.

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I

How do we decide whether a given action is morally right or wrong and hence, assuming the desire to act morally, why it should be undertaken or refrained from? Like the Molière char-

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acter who spoke prose without knowing it, economists who advocate use of cost-benefit analysis for public decisions are philosophers without knowing it: the answer given by cost-benefit analysis, that actions should be undertaken so as to maximize net benefits, represents one of the classic answers given by moral philosophers—that given by utilitarians. To determine whether an action is right or wrong, utilitarians tote up all the positive consequences of the action in terms of human satisfaction. The act that maximizes attainment of satisfaction under the circumstances is the right act. That the economists' answer is also the answer of one school of philosophers should not be surprising. Early on, economics was a branch of moral philosophy, and only later did it become an independent discipline.

Before proceeding further, the subtlety of the utilitarian position should be noted. The positive and negative consequences of an act for satisfaction may go beyond the act's immediate consequences. A facile version of utilitarianism would give moral sanction to a lie, for instance, if the satisfaction of an individual attained by telling the lie was greater than the suffering imposed on the lie's victim. Few utilitarians would agree. Most of them would add to the list of negative consequences the effect of the one lie on the tendency of the person who lies to tell other lies, even in instances when the lying produced less satisfaction for him than dissatisfaction for others. They would also add the negative effects of the lie on the general level of social regard for truth-telling, which has many consequences for future utility. A further consequence may be added as well. It is sometimes said that we should include in a utilitarian calculation the feeling of dissatisfaction produced in the liar (and perhaps in others) because, by telling a lie, one has "done the wrong thing." Correspondingly, in this view, among the positive consequences to be weighed into a utilitarian calculation of truth-telling is satisfaction arising from "doing the right thing." This view rests on an error, however, because it *assumes* what it is the purpose of the calculation to *determine*—that telling the truth in the instance in question is indeed the right thing to do. Economists are likely to object to this point, arguing that no feeling ought "arbitrarily" to be excluded from a complete cost-benefit calculation, including a feeling of dissatisfaction at doing the wrong thing. Indeed, the economists' cost-benefit calculations would, at least ideally, include such feelings. Note the difference between the economist's and the philosopher's cost-benefit calculations, however. The economist may choose to include feelings of dissatisfaction in his cost-benefit calculation, but what happens if somebody asks the economist, "Why is it right to evaluate an action on the basis of a cost-benefit test?" If an answer is to be given to that question (which does not normally preoccupy economists but which does concern both philosophers and the rest of us who need to be persuaded that cost-benefit analysis is right), then the circularity problem reemerges. And there is also another difficulty with counting feelings of dissatisfaction at doing the wrong thing in a cost-benefit calculation. It leads to the perverse result that under certain circumstances a lie, for example, might be morally right if the individual contemplating the lie felt no compunction about lying and morally wrong only if the individual felt such a compunction!

This error is revealing, however, because it begins to suggest a critique of utilitarianism. Utilitarianism is an important and powerful moral doctrine. But it is probably a minority position among contemporary moral philosophers. It is amazing that economists can proceed in unanimous endorsement of cost-benefit analysis as if unaware that their conceptual framework is highly controversial in the discipline from which it arose—moral philosophy.

It is amazing that economists can proceed in unanimous endorsement of cost-benefit analysis as if unaware that their conceptual framework is highly controversial in the discipline from which it arose—moral philosophy.

Let us explore the critique of utilitarianism. The logical error discussed before appears to suggest that we have a notion of certain things being right or wrong that *predates* our calculation of costs and benefits. Imagine the case of an old man in Nazi Germany who is hostile to the regime. He is wondering whether he should speak out against Hitler. If he speaks out, he

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will lose his pension. And his action will have done nothing to increase the chances that the Nazi regime will be overthrown: he is regarded as somewhat eccentric by those around him, and nobody has ever consulted his views on political questions. Recall that one cannot add to the benefits of speaking out any satisfaction from doing "the right thing," because the purpose of the exercise is to determine whether speaking out *is* the right thing. How would the utilitarian calculation go? The benefits of the old man's speaking out would, as the example is presented, be nil, while the costs would be his loss of his pension. So the costs of the action would outweigh the benefits. By the utilitarians' cost-benefit calculation, it would be *morally wrong* for the man to speak out.

Another example: two very close friends are on an Arctic expedition together. One of them falls very sick in the snow and bitter cold, and sinks quickly before anything can be done to help him. As he is dying, he asks his friend one thing, "Please, make me a solemn promise that ten years from today you will come back to this spot and place a lighted candle here to remember me." The friend solemnly promises to do so, but does not tell a soul. Now, ten years later, the friend must decide whether to keep his promise. It would be inconvenient for him to make the long trip. Since he told nobody, his failure to go will not affect the general social faith in promise-keeping. And the incident was unique enough so that it is safe to assume that his failure to go will not encourage him to break other promises. Again, the costs of the act outweigh the benefits. A utilitarian would need to believe that it would be *morally wrong* to travel to the Arctic to light the candle.

A third example: a wave of thefts has hit a city and the police are having trouble finding any of the thieves. But they believe, correctly, that punishing someone for theft will have some deterrent effect and will decrease the number of crimes. Unable to arrest any actual perpetrator, the police chief and the prosecutor arrest a person whom they know to be innocent and, in cahoots with each other, fabricate a convincing case against him. The police chief and the prosecutor are about to retire, so the act has no effect on any future actions of theirs. The fabrication is perfectly executed, so nobody finds out about it. Is the *only* question involved in judging the act of framing the innocent man that of whether his suffering from conviction and imprisonment will be greater than the suffering avoided among potential crime victims when some crimes are deterred? A utilitarian would need to believe that it is *morally right to punish the innocent man* as long as it can be demonstrated that the suffering prevented outweighs his suffering.

And a final example: imagine two worlds, each containing the same sum total of happiness. In the first world, this total of happiness came about from a series of acts that included a number of lies and injustices (that is, the total consisted of the immediate gross sum of happiness created by certain acts, minus any long-term unhappiness occasioned by the lies and injustices). In the second world the same amount of happiness was produced by a different series of acts, none of which involved lies or injustices. Do we have any reason to prefer the one world to the other? A utilitarian would need to believe that the choice between the two worlds is a *matter of indifference.*

To those who believe that it would not be morally wrong for the old man to speak out in Nazi Germany or for the explorer to return to the Arctic to light a candle for his deceased friend, that it would not be morally right to convict the innocent man, or that the choice between the two worlds is not a matter of indifference—to those of us who believe these things, utilitarianism is insufficient as a moral view. We believe that some acts whose costs are greater than their benefits may be morally right and, contrariwise, some acts whose benefits are greater than their costs may be morally wrong.

This does not mean that the question whether benefits are greater than costs is morally irrelevant. Few would claim such. Indeed, for a broad range of individual and social decisions, whether an act's benefits outweigh its costs is a sufficient question to ask. But not for all such decisions. These may involve situations where certain duties—duties not to lie, break promises, or kill, for example—make an act wrong, even if it would result in an excess of benefits over costs. Or they may involve instances where people's rights are at stake. We would not permit rape even if it could be demonstrated that the rapist derived enormous happiness from his act, while the victim experienced only minor displeasure. We do not do cost-benefit analyses of freedom of speech or

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trial by jury. The Bill of Rights was not RARGed. As the United Steelworkers noted in a comment on the Occupational Safety and Health Administration's economic analysis of its proposed rule to reduce worker exposure to carcinogenic coke-oven emissions, the Emancipation Proclamation was not subjected to an inflationary impact statement. The notion of human rights involves the idea that people may make certain claims to be allowed to act in certain ways or to be treated in certain ways, even if the sum of benefits achieved thereby does not outweigh the sum of costs. It is this view that underlies the statement that "workers have a right to a safe and healthy work place" and the expectation that OSHA's decisions will reflect that judgment.

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In the most convincing versions of non-utilitarian ethics, various duties or rights are not absolute. But each has a *prima facie* moral validity so that, if duties or rights do not conflict, the morally right act is the act that reflects a duty or respects a right. If duties or rights do conflict, a moral judgment, based on conscious deliberation, must be made. Since one of the duties non-utilitarian philosophers enumerate is the duty of beneficence (the duty to maximize happiness), which in effect incorporates all of utilitarianism by reference, a non-utilitarian who is faced with conflicts between the results of cost-benefit analysis and non-utility-based considerations will need to undertake such deliberation. But in that deliberation, additional elements, which cannot be reduced to a question of whether benefits outweigh costs, have been introduced. Indeed, depending on the moral importance we attach to the right or duty involved, cost-benefit questions may, within wide ranges, become irrelevant to the outcome of the moral judgment.

In addition to questions involving duties and rights, there is a final sort of question where, in my view, the issue of whether benefits outweigh costs should not govern moral judgment. I noted earlier that, for the common run of questions facing individuals and societies, it is possible to begin and end our judgment simply by finding out if the benefits of the contemplated act outweigh the costs. This very fact means that one way to show the great importance, or value, attached to an area is to say that decisions involving the area should not be determined by cost-benefit calculations. This applies, I think, to the view many environmentalists have of decisions involving our natural environment. When officials are deciding what level of pollution will harm certain vulnerable people—such as asthmatics or the elderly—while not harming others, one issue involved may be the right of those people not to be sacrificed on the altar of somewhat higher living standards for the rest of us. But more broadly than this, many environmentalists fear that subjecting decisions about clean air or water to the cost-benefit tests that determine the general run of decisions removes those matters from the realm of specially valued things.

II

In order for cost-benefit calculations to be performed the way they are supposed to be, all costs and benefits must be expressed in a common measure, typically dollars, including things not normally bought and sold on markets, and to which dollar prices are therefore not attached. The most dramatic example of such things is human life itself; but many of the other benefits achieved or preserved by environmental policy—such as peace and quiet, fresh-smelling air, swimmable rivers, spectacular vistas—are not traded on markets either.

Economists who do cost-benefit analysis regard the quest after dollar values for non-market things as a difficult challenge—but one to be met with relish. They have tried to develop methods for imputing a person's "willingness to pay" for such things, their approach generally involving a search for bundled goods that *are* traded on markets and that vary as to whether they include a feature that is, *by itself*, not marketed. Thus, fresh air is not marketed, but houses in different parts of Los Angeles that are similar except for the degree of smog are. Peace and quiet is not marketed, but similar houses inside and outside airport flight paths

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are. The risk of death is not marketed, but similar jobs that have different levels of risk are. Economists have produced many often ingenious efforts to impute dollar prices to non-marketed things by observing the premiums accorded homes in clean air areas over similar homes in dirty areas or the premiums paid for risky jobs over similar nonrisky jobs.

These ingenious efforts are subject to criticism on a number of technical grounds. It may be difficult to control for all the dimensions of quality other than the presence or absence of the non-marketed thing. More important, in a world where people have different preferences and are subject to different constraints as they make their choices, the dollar value imputed to the non-market things that most people would wish to avoid will be lower than otherwise, because people with unusually weak aversion to those things or unusually strong constraints on their choices will be willing to take the bundled good in question at less of a discount than the average person. Thus, to use the property value discount of homes near airports as a measure of people's willingness to pay for quiet means to accept as a proxy for the rest of us the behavior of those least sensitive to noise, of airport employees (who value the convenience of a near-airport location) or of others who are susceptible to an agent's assurances that "it's not so bad." To use the wage premiums accorded hazardous work as a measure of the value of life means to accept as proxies for the rest of us the choices of people who do not have many choices or who are exceptional risk-seekers.

A second problem is that the attempts of economists to measure people's willingness to pay for non-marketed things assume that there is no difference between the price a person would require for *giving up* something to which he has a preexisting right and the price he would pay to *gain* something to which he enjoys no right. Thus, the analysis assumes no difference between how much a homeowner would need to be paid in order to give up an unobstructed mountain view that he already enjoys and how much he would be willing to pay to get an obstruction moved once it is already in place. Available evidence suggests that most people would insist on being paid far more to assent to a worsening of their situation than

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"Good Lord, Gilroy, it's not for us to determine whether they're worth *saving."*

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they would be willing to pay to improve their situation. The difference arises from such factors as being accustomed to and psychologically attached to that which one believes one enjoys by right. But this creates a circularity problem for any attempt to use cost-benefit analysis to determine *whether* to assign to, say, the homeowner the right to an unobstructed mountain view. For willingness to pay will be different depending on whether the right is assigned initially or not. The value judgment about whether to assign the right must thus be made first. (In order to set an upper bound on the value of the benefit, one might hypothetically assign the right to the person and determine how much he would need to be paid to give it up.)

Third, the efforts of economists to impute willingess to pay invariably involve bundled goods exchanged in *private* transactions. Those who use figures garnered from such analysis to provide guidance for *public* decisions assume no difference between how people value certain things in private individual transactions and how they would wish those same things to be valued in public collective decisions. In making such assumptions, economists insidiously slip into their analysis an important and controversial value judgment, growing naturally out of the highly individualistic microeconomic tradition—namely, the view that there should be no difference between private behavior and the behavior we display in public social life. An alternative view—one that enjoys, I would suggest, wide resonance among citizens—would be that public, social decisions provide an opportunity to give certain things a higher valuation than we choose, for one reason or another, to give them in our private activities.

Thus, opponents of stricter regulation of health risks often argue that we show by our daily risk-taking behavior that we do not value life infinitely, and therefore our public decisions should not reflect the high value of life that proponents of strict regulation propose. However, an alternative view is equally plausible. Precisely because we fail, for whatever reasons, to give life-saving the value in everyday personal decisions that we in some general terms believe we should give it, we may wish our social decisions to provide us the occasion to display the reverence for life that we espouse but do not always show. By this view, people do not have fixed unambiguous "preferences" to which they give expression through private activities and which therefore should be given expression in public decisions. Rather, they

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may have what they themselves regard as "higher" and "lower" preferences. The latter may come to the fore in private decisions, but people may want the former to come to the fore in public decisions. They may sometimes display racial prejudice, but support antidiscrimination laws. They may buy a certain product after seeing a seductive ad, but be skeptical enough of advertising to want the government to keep a close eye on it. In such cases, the use of private behavior to impute the values that should be entered for public decisions, as is done by using willingness to pay in private transactions, commits grievous offense against a view of the behavior of the citizen that is deeply engrained in our democratic tradition. It is a view that denudes politics of any independent role in society, reducing it to a mechanistic, mimicking recalculation based on private behavior.

Finally, one may oppose the effort to place prices on a non-market thing and hence in effect incorporate it into the market system out of a fear that the very act of doing so will reduce the thing's perceived value. To place a price on the benefit may, in other words, reduce the value of that benefit. Cost-benefit analysis thus may be like the thermometer that, when placed in a liquid to be measured, itself changes the liquid's temperature.

Examples of the perceived cheapening of a thing's value by the very act of buying and selling it abound in everyday life and language. The disgust that accompanies the idea of buying and selling human beings is based on the sense that this would dramatically diminish human worth. Epithets such as "he prostituted

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himself," applied as linguistic analogies to people who have sold something, reflect the view that certain things should not be sold because doing so diminishes their value. Praise that is bought is worth little, even to the person buying it. A true anecdote is told of an economist who retired to another university community and complained that he was having difficulty making friends. The laconic response of a critical colleague—"If you want a friend why don't you buy yourself one"—illustrates in a pithy way the intuition that, for some things, the very act of placing a price on them reduces their perceived value.

The first reason that pricing something decreases its perceived value is that, in many circumstances, non-market exchange is associated with the production of certain values not associated with market exchange. These may include spontaneity and various other feelings that come from personal relationships. If a good becomes less associated with the production of positively valued feelings because of market exchange, the perceived value of the good declines to the extent that those feelings are valued. This can be seen clearly in instances where a thing may be transferred both by market and by non-market mechanisms. The willingness to pay for sex bought from a prostitute is less than the perceived value of the sex consummating love. (Imagine the reaction if a practitioner of cost-benefit analysis computed the benefits of sex based on the price of prostitute services.)

Furthermore, if one values in a general sense the existence of a non-market sector because of its connection with the production of certain valued feelings, then one ascribes added value to any non-marketed good simply as a repository of values represented by the non-market sector one wishes to preserve. This seems certainly to be the case for things in nature, such as pristine streams or undisturbed forests: for many people who value them, part of their value comes from their position as repositories of values the non-market sector represents.

The second way in which placing a market price on a thing decreases its perceived value is by removing the possibility of proclaiming that the thing is "not for sale," since things on the market by definition are for sale. The very statement that something is not for sale affirms, enhances, and protects a thing's value in a number of ways. To begin with, the statement is a way of showing that a thing is valued for its own sake, whereas selling a thing for money demonstrates that it was valued only instrumentally. Furthermore, to say that something cannot be transferred in that way places it in the exceptional category—which requires the person interested in obtaining that thing to be able to offer something else that is exceptional, rather than allowing him the easier alternative of obtaining the thing for money that could have been obtained in an infinity of ways. This enhances its value. If I am willing to say "You're a really kind person" to whoever pays me to do so, my praise loses the value that attaches to it from being exchangeable only for an act of kindness.

In addition, if we have already decided we value something highly, one way of stamping it with a cachet affirming its high value is to announce that it is "not for sale." Such an announcement does more, however, than just reflect a preexisting high valuation. It signals a thing's distinctive value to others and helps us persuade them to value the thing more highly than they otherwise might. It also expresses our resolution to safeguard that distinctive value. To state that something is not for sale is thus also a source of value for that thing, since if a thing's value is easy to affirm or protect, it will be worth more than an otherwise similar thing without such attributes.

If we proclaim that something is not for sale, we make a once-and-for-all judgment of its special value. When something is priced, the issue of its perceived value is constantly coming up, as a standing invitation to reconsider that original judgment. Were people constantly faced with questions such as "how much money could get you to give up your freedom of speech?" or "how much would you sell your vote for if you could?", the perceived value of the freedom to speak or the right to vote would soon become devastated as, in moments of weakness, people started saying "maybe it's not worth *so much* after all." Better not to be faced with the constant questioning in the first place. Something similar did in fact occur when the slogan "better red than dead" was launched by some pacifists during the Cold War. Critics pointed out that the very posing of this stark choice—in effect, "would you *really* be willing

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to give up your life in exchange for not living under communism?"—reduced the value people attached to freedom and thus diminished resistance to attacks on freedom.

Finally, of some things valued very highly it is stated that they are "priceless" or that they have "infinite value." Such expressions are reserved for a subset of things not for sale, such as life or health. Economists tend to scoff at talk of pricelessness. For them, saying that something is priceless is to state a willingness to trade off an infinite quantity of all other goods for one unit of the priceless good, a situation that empirically appears highly unlikely. For most people, however, the word priceless is pregnant with meaning. Its value-affirming and value-protecting functions cannot be bestowed on expressions that merely denote a determinate, albeit high, valuation. John Kennedy in his inaugural address proclaimed that the nation was ready to "pay any price [and] bear any burden . . . to assure the survival and the success of liberty." Had he said instead that we were willing to "pay a high price" or "bear a large burden" for liberty, the statement would have rung hollow.

III

An objection that advocates of cost-benefit analysis might well make to the preceding argument should be considered. I noted earlier that, in cases where various non-utility-based duties or rights conflict with the maximization of utility, it is necessary to make a deliberative judgment about what act is finally right. I also argued earlier that the search for commensurability might not always be a desirable one, that the attempt to go beyond expressing benefits in terms of (say) lives saved and costs in terms of dollars is not something devoutly to be wished.

In situations involving things that are not expressed in a common measure, advocates of cost-benefit analysis argue that people making judgments "in effect" perform cost-benefit calculations anyway. If government regulators promulgate a regulation that saves 100 lives at a cost of $1 billion, they are "in effect" valuing a life at (a minimum of) $10 million, whether or not they say that they are willing to place a dollar value on a human life. Since, in this view, cost-benefit analysis "in effect" is inevitable, it might as well be made specific.

This argument misconstrues the real difference in the reasoning processes involved. In cost-benefit analysis, equivalencies are established *in advance* as one of the raw materials for the calculation. One determines costs and benefits, one determines equivalencies (to be able to put various costs and benefits into a common measure), and then one sets to toting things up—waiting, as it were, with bated breath for the results of the calculation to come out. The outcome is determined by the arithmetic; if the outcome is a close call or if one is not good at long division, one does not know how it will turn out until the calculation is finished. In the kind of deliberative judgment that is performed without a common measure, no establishment of equivalencies occurs in advance. Equivalencies are not aids to the decision process. In fact, the decision-maker might not even be aware of what the "in effect" equivalencies were, at least before they are revealed to him afterwards by someone pointing out what he had "in effect" done. The decision-maker would see himself as simply having made a deliberative judgment; the "in effect" equivalency number did not play a causal role in the decision but at most merely reflects it. Given this, the argument against making the process explicit is the one discussed earlier in the discussion of problems with putting specific quantified values on things that are not normally quantified—that the very act of doing so may serve to reduce the value of those things.

MY OWN JUDGMENT is that modest efforts to assess levels of benefits and costs are justified, although I do not believe that government agencies ought to sponsor efforts to put dollar prices on non-market things. I also do not believe that the cry for more cost-benefit analysis in regulation is, on the whole, justified. If regulatory officials were so insensitive about regulatory costs that they did not provide acceptable raw material for deliberative judgments (even if not of a strictly cost-benefit nature), my conclusion might be different. But a good deal of research into costs and benefits already occurs—actually, far more in the U.S. regulatory process than in that of any other industrial society. The danger now would seem to come more from the other side. ■

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The High Cost of Regulating U.S. Railroads

Douglas W. Caves, Laurits R. Christensen, and Joseph A. Swanson

THE STAGGERS RAIL ACT, signed into law in October 1980, offers a step toward deregulating U.S. railroads. It is hardly likely, however, to quiet the controversy over rail regulation in the United States. On the one hand, the act falls far short of total deregulation. On the other, it is expected to cause sizable rate increases for some shippers and loss of service for others. It will be surprising if these events do not evoke calls for the reimposition of controls from the affected parties.

In the face of what is likely to be continuing controversy, it will be important for policy makers to understand the magnitude of the costs imposed by the complex system of controls that has governed rail operations throughout this century. The deleterious effects of those controls have often been cited, but actual evidence of their cost is meager. Moreover, what there is pertains to the misallocation of freight traffic among transport modes as a result of rate regulation, where the estimated losses have generally been relatively small. Experts have conjectured, however, that losses from poor productivity growth are much greater.

The principal problem in assessing such losses is estimating how the industry might have performed in a more free environment. Fortunately, this problem can be solved for the rail industry by comparing U.S. railroads with their counterparts in Canada. The rail systems of the two countries are strikingly similar in many physical and technical aspects. The crucial difference between them is that the Canadian railroads have been operating for years under far less regulation than U.S. railroads. Thus, the economic performance of the Canadian roads provides a yardstick for measuring performance under the more regulated environment in this country. In effect, what we have done in the research whose results we

. . . regulation has greatly retarded the productivity growth of U.S. railroads. The resulting costs have accumulated year by year to an astounding magnitude—$6.7 billion in 1974 alone.

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summarize here is to take advantage of an historical happenstance. By comparing the two systems, we have found strong evidence that regulation has greatly retarded the productivity growth of U.S. railroads. The resulting costs have accumulated year by year to an astounding magnitude—$6.7 billion in 1974 alone.

Comparing Environments

Before World War II both U.S. and Canadian railroads had substantial monopoly power. After the war, however, they began to face significant competition from trucks and water transport. This competition, which was aided by government investment in highways and waterways, resulted in declining market shares for the railroads in both countries—from approximately 75 percent in 1946 to approximately 60 percent in the mid-1950s.

Low earnings of the railroads in the postwar period led to the establishment of government review committees in both the United States and Canada. In 1955, both committees recommended that competition be allowed to play a greater role in rail transportation. In Canada the recommendation brought substantial deregulation. The railroads were given considerable freedom to negotiate rates with shippers in 1956, and the industry was even further deregulated by the National Transportation Act of 1967. In the United States, by contrast, the recommendation had little effect. A Transportation Act was passed in 1958, but it did not result in any significant reduction in rail regulation. The U.S. railroads continued to have little pricing freedom, and attempts to gain more flexibility through selective ratemaking (negotiation of rates between carrier and shipper) were generally thwarted by an anachronistic regulatory tradition that encouraged protection of potentially "injured" competitors.

Thus, since 1956, the U.S. and Canadian rail systems have operated under very different regulatory regimes. Aside from this difference, the environments for the two systems have been remarkably similar. There has been equal access to improvements in technology. Furthermore, railway labor practices have been much alike because, to a considerable extent, the same unions represent railroad employees in both countries.

If anything, the U.S. railroads are better off than their Canadian counterparts in two ways. First, Canada's harsher climate imposes major costs on Canadian railroads, both in terms of train movements and maintenance. Second, Canadian railroads incur large deficits in hauling grain and flour destined for export because they are required by law to haul these commodities, which accounted for 27 percent of their total ton-miles in 1973, at the rates that prevailed in 1897. These deficits must be covered by revenues from other haulage, which makes it more difficult for Canadian railroads to compete with other forms of transport.

Comparing Productivity

The best single measure of economic performance is growth in overall (or total factor) productivity, and we have adopted this measure for comparing the performance of U.S. and Canadian railroads. Overall productivity growth is equivalent to a decline in the real cost (of labor, capital, energy, and all materials) per unit of output. Thus, it is convenient to estimate productivity growth by fitting a statistical cost function (that is, using statistical techniques to find the relationship between cost and its determinants). This framework makes it possible to control for differences in the two countries and in the railroads we examine. In the figures reported here, we have controlled for the level of output, for the length of freight hauls and passenger trips, and for the prices of railroads inputs. (We have estimated other variants, all of which result in similar conclusions.) Thus our measure of productivity growth includes only those cost reductions that actually result from improvements in efficiency. It does not include cost savings that might result from a larger scale of operations or from longer freight hauls or passenger trips.

We have used data for a sample of U.S. Class I railroads and for the only two large Canadian railroads, the Canadian National and the Canadian Pacific. Reliable data on Canada's railroads have only been available since 1956. This is an appropriate starting point, however, since it coincides with the advent of regulatory freedom for Canadian railroads. In addition we have analyzed detailed data for 1963 and 1974. Thus we compare productivity growth over the

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full 1956–74 period and the two interim periods, 1956–63 and 1963–74.

The first two lines of Table 1 present our estimates of productivity growth for U.S. and Canadian railroads. In the 1956–63 period, Canadian railroads experienced productivity growth of 1.7 percent a year compared to 0.6 percent for U.S. railroads. The big difference came after 1963, when Canadian railroad productivity growth rose to 4.0 percent a year, while that of the United States dropped to 0.1 percent. Over the full period the Canadian gain of 3.3 percent a year is more than six times greater than the U.S. gain of 0.5 percent.

It might be objected that the comparison is intrinsically unfavorable to the U.S. industry since the U.S. data include a large number of weak and relatively small railroads. However, because the clear direction of the U.S. railroad industry has been to emulate the example of the Canadian industry—creating through mergers a small number of large railroads—the objection can be met by comparing the Canadian National (CN) and the Canadian Pacific (CP) with U.S. railroads having similar characteristics. For this purpose, we have selected the Atchison, Topeka, and Santa Fe (SF) and the Southern Pacific (SP)—two U.S. carriers that stand out as being similar to the CN and the CP and that are generally regarded as being among the strongest U.S. railroads.

The last four lines of Table 1 present the average annual growth in overall productivity for each of the four railroads. CN and CP productivity growth rates fell between those of the SF and SP in the earlier of the two periods covered but clearly moved ahead in the later period and were significantly higher for the full period, 1956–74. The productivity performances of the SF and SP were, it should be noted, somewhat better than those of the typical U.S. railroad but still far below those of the Canadian railroads.

Several factors (like climate) that differ between the United States and Canada but do not vary over time have been omitted in our analysis. These factors do not, however, affect our comparisons of productivity *growth*, although they do affect comparisons of *levels* of productivity between the U.S. and Canadian railroads. In effect, a comparison of productivity levels will include cost differences attributable to climate and other factors in addition to cost differences stemming from productive efficiency. The result of the differences is generally to increase costs for Canadian railroads, thereby putting them at a disadvantage in the comparison. Nonetheless, as long as this qualification is kept in mind, it is worthwhile to examine the relative levels of productivity for U.S. and Canadian railroads.

Table 1
OVERALL PRODUCTIVITY GROWTH FOR U.S. AND CANADIAN RAILROADS
(average annual percentages)

	1956–63	1963–74	1956–74
Canada	1.7	4.0	3.3
United States	0.6	0.1	0.5
Canadian National	1.8	4.3	3.3
Canadian Pacific	1.7	3.3	2.7
Atchison, Topeka and Santa Fe	1.4	1.0	1.1
Southern Pacific	3.1	0.4	1.4

Table 2
COMPARISON OF OVERALL PRODUCTIVITY FOR U.S. AND CANADIAN RAILROADS
(ratios)

	1956	1963	1974
United States/Canada	1.24	1.15	.82
Atchison, Topeka and Santa Fe/Canadian National	1.22	1.18	.82
Southern Pacific/Canadian National	1.33	1.45	.95
Atchison, Topeka and Santa Fe/Canadian Pacific	1.07	1.05	.81
Southern Pacific/Canadian Pacific	1.17	1.29	.94

Table 2 presents that comparison. The first line indicates that a U.S. railroad with characteristics similar to those of the Canadian railroads had a 24 percent higher level of productivity (hence a ratio of 1.24) than the Canadian railroads in 1956. This superiority had declined to 15 percent by 1963, and by 1974 U.S. railroads had fallen 18 percent behind. The figures are very similar for comparisons of the individual railroads. In all cases, the Canadian productivity levels were superior by 1974.

Our finding that Canadian railroads had much lower productivity levels in the mid-1950s than U.S. railroads is consistent with the general view that railroading is inherently more costly in Canada because of harsher climate. Since then, as noted, the relative productivity levels of the two systems have been reversed. The Canadian gains cannot be attributed to climatic changes, which have not occurred. Nor can they be attributed to changes in economic

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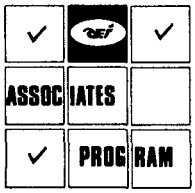

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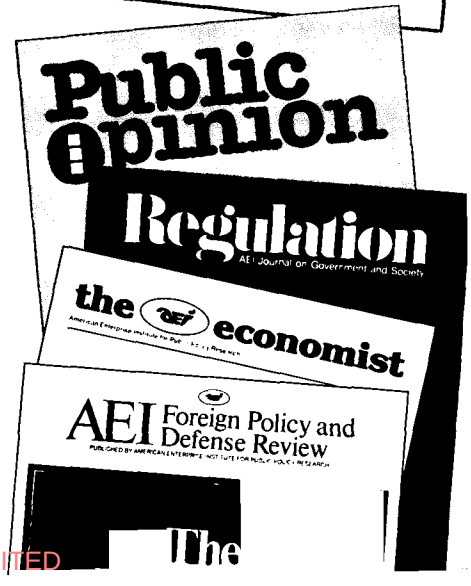

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factors: while the general economic environments in the two countries have changed, they have changed in markedly similar ways.

Why, then, has the Canadian performance been superior? The evidence strongly suggests that the answer is the greater regulatory freedom in Canada. Indeed, during the period in which the economic performance of Canada's railroads has far exceeded that of U.S. railroads, the only major differential change in the environments of the two systems has been the Canadian deregulation.

The Cost to U.S. Consumers

It is of interest to know the dollar magnitude of the losses associated with poor productivity growth in U.S. railroads. In 1974 expenses for all Class I U.S. railroads totaled nearly $17 billion. Between 1956 and 1974 the decline in real cost per unit of output averaged 3.3 percent a year for Canadian railroads but only 0.5 percent for U.S. railroads. Compounding this difference between 1956 and 1974, we find that the cost of producing railroad services in the United States in 1974 was $6.7 billion higher than it would have been with the Canadian rate of railroad productivity growth. This is $6.7 billion for 1974 alone. It is clear that cumulating these "excess" costs over the post-World War II period would result in an enormous figure. This finding supports the conjectures of other writers that losses from forgone productivity growth are much larger than losses from the misallocation of freight traffic.

Conclusions

Analysts have speculated at length on the possible connections between regulation and the retardation of productivity growth. We believe that the most direct link is through the ratemaking process. Freedom to negotiate rates provides railroads with a means of attracting the kinds and amounts of traffic that fit in well with existing networks, traffic patterns, and stocks of equipment. Also important, in our view, is the fact that ratemaking freedom provides incentives for the development of new or more efficient services. Often the introduction of such services entails heavy costs that can be justified only if rates can be set so that sufficient profitable traffic is generated.

The most obvious manifestation of the exceptional productivity performance of the Canadian railroads is their more efficient use of equipment. On average, a Canadian freight car generates more revenue ton miles a year than a U.S. freight car. One reason for this is the reduction of empty back-hauls; another is better control over the movement of empty cars to where they are needed. Largely because of these reasons, the Canadian railroads have been able to accommodate traffic growth with modest increases in rolling stock. U.S. railroads, on the other hand, have difficulty in handling additional traffic and experience recurrent "shortages" of capacity. Greater reliance on market mechanisms would surely ease such problems.

The recently passed Staggers Rail Act should improve the regulatory climate for U.S. railroads. To the extent that it brings rail regulation in the United States closer to that in Canada (an issue not examined here), and to the extent that policy makers can resist calls for re-regulation, there is good reason to expect better performance from the U.S. railroad industry. But not, of course, dramatic improvements right away. Just as the costs of impaired productivity growth accumulated gradually, so the initial benefits from revived productivity are likely to be modest.

In any event, much mischief will be avoided if the public's attention can be captured by the lure of the huge long-term benefits that Canadian-type deregulation would bring. ■

Selected Readings

For background and further detail on the research reported here, see: "Productivity and U.S. Railroads, 1951–1974" by D. W. Caves, L. R. Christensen, and J. A. Swanson, in *Bell Journal of Economics*, vol. 11, no. 1 (Spring 1980); "The Relative Efficiency of Public and Private Firms in a Competitive Environment: The Case of Canadian Railroads" by Caves and Christensen, in *Journal of Political Economy*, vol. 88, no. 5 (October 1980); "Productivity Growth, Scale Economies, and Capacity Utilization in U.S. Railroads, 1955–1974" by Caves, Christensen, and Swanson, Social Systems Research Institute, University of Wisconsin-Madison, Discussion Paper 8002 (forthcoming in *American Economic Review*); and "Economic Performance in Regulated and Unregulated Environments: A Comparison of U.S. and Canadian Railroads" by Caves, Christensen, and Swanson, SSRI Discussion Paper 8004.

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Readings
of particular interest

Antitrust as Big Business

"The Antitrust Industry" by Robert B. Reich, in the *Georgetown Law Journal*, vol. 68 (June 1980), pp. 1053-1073.

Antitrust is more than a body of law; it is also an industry. The industry is composed of attorneys, legislators, corporate officials, bureaucrats, law professors, consultants, and economists—all of whose transactions give the legal doctrines practical effect, shape countless business decisions, and determine the future course of antitrust jurisprudence. Robert B. Reich, director of policy planning at the Federal Trade Commission, describes the structure of this industry and argues that the motives of those who participate in it are often at odds with the objectives antitrust is designed to serve.

According to Reich's calculations, approximately $2.5 billion of antitrust was "sold" in 1979—including $2.1 billion for private attorneys, $81 million for government attorneys, $17 million for judges, $30 million for economists and consultants, and $290 million for duplicating paper, telephone calls, and the ubiquitous travel and hotel accommodations. This sum does not include the indirect costs of antitrust, such as economies forgone due to the threat of antitrust prosecution.

The transactions of the antitrust industry take on a great deal of importance, Reich says, because the higher courts so infrequently articulate the law. Of the few cases that become full-blown controversies, fewer proceed to litigation, still fewer result in final decrees, and only a small portion of these are appealed.

The "buyers" of antitrust services are not necessarily those predicted by the theory that underlies antitrust, Reich says. The theories of monopoly commonly cited as the basis for antitrust law suggest three possible beneficiaries of antitrust enforcement who might serve as "buyers": consumers, seeking to reduce prices; smaller firms, seeking to lower barriers to entry into certain markets; and larger firms, seeking to prevent collusion among suppliers or competitors. None of these groups, observes Reich, has proved to be a determined force for antitrust enforcement. Consumers are too disorganized, and their individual interests in single controversies too small. Smaller firms are often more interested in getting the government to curb competition in their own markets than in challenging firms in other markets. Where these firms do resort to the antitrust laws, it is often to seek protection against wholesale discounting or to ward off unfriendly takeovers. Such uses of the antitrust laws, according to Reich, "rarely, if ever, benefit consumers" and may harm them. Finally, larger firms are often more concerned with avoiding antitrust liability themselves, either by obtaining legal exemptions or through their unlimited willingness to litigate, than with charging other firms with collusion.

Antitrust "sellers"—government enforcers, plaintiffs' counsel, outside defense counsel, and information processors—have their own set of interests and motives. Government attorneys are apt to be judged by the sheer number of antitrust cases they successfully prosecute during their (often brief) tenure, while senior officials may be eager to file highly visible actions unlikely ever to come to fruition. Plaintiffs' counsel are likely to act as venture capitalists, Reich says, seeking out potential defendants and plaintiffs according to the likely return on their own time and effort. Outside defense counsel—more concerned about avoiding mistakes and maintaining their reputations for thoroughness than about saving clients' money—are apt to overprescribe their antitrust services. And information processors—such as antitrust law professors, authors of looseleaf services and treatises, economists, management consultants, and hordes of overworked paralegals—are likely to be a force for change and com-

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plexity in antitrust regardless of the desirability of such refinements.

In the light of the perverse incentives of many of these buyers and sellers, Reich examines the possibilities for less expensive means of achieving the purposes of antitrust. He offers several suggestions: (1) tax incentives designed to encourage firms to enter particular markets that appear to have substantial barriers to entry; (2) tax reforms designed to allow new entrants to carry forward their business-expense deductions at appreciated market value, so that their future profits can be offset to the same extent that present deductions can offset the present taxable earnings of "incumbents"; (3) requirements that incumbents disclose their profitability by line of business, in order to inform potential entrants of attractive market opportunities; (4) requirements that all firms disclose product quality attributes, in order to inform consumers that a new entrant's brand may be superior to an incumbent's better-established brand; and (5) expansion of the exemption from the Securities Act of 1933 of smaller issues, and clarification and simplification of the exemption for private offerings, in order to give new entrants easier access to capital markets. Such alternative ways to encourage market entry, argues Reich, might create fewer incentives for costly strategic behavior than does antitrust.

Nuclear Regulation: The European Example

"How Prometheus Came to Be Bound" by Michael Golay, in *Technology Review*, June/July 1980, pp. 29-39.

The regulation of nuclear plant construction in Europe is largely free of the delays and uncertainty that characterize its U.S. counterpart, according to Michael Golay, professor of nuclear engineering at the Massachusetts Institute of Technology. As part of a project sponsored by the Energy Department, Golay surveyed nuclear regulation in France, England, West Germany, and Sweden. "Uniformly," Golay writes, "both electric utility and regulatory personnel report that unjustified licensing delays are not significant factors in nuclear projects" in the four countries.

By contrast, adds Golay, delays were commonplace in the United States even before Three Mile Island. The period between a plant's construction permit and its operating license has drifted up from five to over seven years, and a licensing delay for a single completed plant can cost as much as $320,000 per day.

The difference, Golay maintains, is directly traceable to the political structures prevailing on each side of the Atlantic. Here neither Congress nor the executive has been willing to formulate a coherent policy for balancing the risks and benefits of nuclear power. Instead we have established a licensing system affording the maximum opportunity for intervention by outside pressure groups. The optimal strategy for nuclear opponents has been to wage a plant-by-plant war of attrition, challenging the licensing procedure at every stage—with the inevitable result being random delay.

In Europe, central governments consciously decide where to strike the balance between safety and economic factors, and the resulting policy is implemented with relatively few chances for private groups to challenge the process. While nuclear opponents have engaged in litigation and some violence, they have perforce had to concentrate on changing overall policy by replacing the government in a general election, as happened in Sweden in 1976.

According to Golay, the European regulators generally rely heavily on the professional judgment of a relatively small staff, often with a low turnover rate. What Golay calls "a sense of cooperation, trust, and reasonable compromise" characterizes the European process. So does secrecy: in England nuclear negotiation is shrouded by an official secrets act, and in France even the names of responsible officials are unavailable to the public.

The typical American practice, on the other hand, is to codify in great detail the standards and procedures the regulators must follow—making licensure a "judicial" as opposed to "legislative" matter, in Golay's words—with the broadest possible scope for outside scrutiny. Sweden and West Germany, which like the United States have a moratorium in effect on nuclear construction (but unlike the United States have made it official), fall somewhere between the two extremes on disclosure.

Golay is not optimistic about the prospects for pulling nuclear power out of its procedural

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thickets, especially since similar constraints are beginning to affect coal-fired plants and other non-nuclear power sources. A coherent policy may emerge, he suggests, only after serious power shortages cause enough economic distress to focus the collective attention of the U.S. government on the problem.

Sex Discrimination in Insurance

"Sex Discrimination in Employer-Sponsored Insurance Plans: A Legal and Demographic Analysis" by Lea Brilmayer, Richard W. Hekeler, Douglas Laycock, and Teresa A. Sullivan, in *The University of Chicago Law Review*, vol. 47 (Spring 1980), pp. 505-560.

In *City of Los Angeles* v. *Manhart* (1978), the Supreme Court held that using sex-based actuarial tables to calculate employee fringe benefits violates Title VII of the 1964 Civil Rights Act. In this article the authors—two lawyers and two demographers from the University of Chicago—respond to the controversy over that decision.

The authors place the issue in the context of the two kinds of sex discrimination forbidden by Title VII: disparate treatment of individuals because of sex, and equal treatment of individuals that has disparate impact on sexual groups. It is disparate treatment to pay women smaller pensions, even though on average women live longer than men; this is analogous to not hiring women because on average they cannot lift as much weight as men. The insurance industry makes a disparate impact argument: that because of their shorter life expectancy, men as a group will receive a smaller proportion of total benefits if monthly payments are equal. The industry also claims that unequal payments produce equal expected values for male and female annuities. But this is just a reformulation of the group average argument, and it assumes that expected values should be computed separately by sex, which is the very question to be answered.

The authors argue strongly that the statutory ban on disparate treatment is primary and must be enforced even at the cost of disparate impact; that the exceptions to the Equal Pay Act, incorporated into Title VII by the Bennett Amendment, mean that disparate impact by sex in compensation is not forbidden at all; and that none of the recognized exceptions to the ban on disparate treatment authorizes unequal insurance benefits. They chide those who oppose quotas in the affirmative action context but support a group approach to equality on this issue.

In rejecting proposals for a special exception to Title VII, the authors assert that no such exception would be consistent with the policies of the statute; that the characteristics of sex that justify its inclusion in Title VII are fully applicable to the insurance context; and that age does not fully share those characteristics, so the explicit insurance exception in the Age Discrimination in Employment Act is consistent with the omission of such an exception from Title VII. Moreover, the argument that sex-based tables are essential to sound insurance practice is refuted by experience with unisex plans and, in any event, is indistinguishable from the long-rejected argument that sex is the only predictor of success in certain jobs.

In the authors' view, their interpretation of Title VII does not depend on the reasons for sex differentials in mortality (SMDs). But many proponents of sex-based insurance tables argue that lower female mortality is universal and genetic, and rely on this claim to distinguish sex-based tables from admittedly illegal race-based tables. The authors review the demographic and biological research and find that "all major investigators now believe that social, cultural, environmental, and behavioral factors are more important than genetic or biological factors in explaining SMDs."

Far from being universal, lower female mortality is a recent phenomenon, concentrated at older ages in the most developed countries. Even within the United States, SMDs vary widely over time and space. From 1920 to 1970, the SMD as measured by life expectancy at birth in the United States increased from 1.0 year to 7.7 years. This change was far too rapid to have a genetic explanation. Rather, the most important causes of SMDs appear to be men's higher rates of such self-destructive behavior as smoking, drinking, and reckless driving. These factors are changeable, and the authors report some evidence that a decline in SMDs has begun. Male death rates in the United States are now dropping faster than female rates. The authors conclude that the associa-

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tion between sex and mortality is largely spurious, and suggest that men who wish to live longer and collect more annuity payments should change their behavior rather than their sex.

Finally, they argue that whatever the causes of SMDs, the fact that they can change as much as 670 percent in the adult life of a single insured makes sex a useless predictor of mortality for insurance purposes. (See "Department of Anticipated Consequences," page 6.)

Federalism and Bank Regulation

"The Patchwork Quilt: State and Federal Roles in Bank Regulation" by Kenneth E. Scott, in *Stanford Law Review*, vol. 32 (April 1980), pp. 687-742.

Regulation of banking in the United States has long been an object lesson in federalism. Despite the institutional division between national and state banks, many state regulations bind national banks and vice versa. State laws vary tremendously, especially on matters of branching and multiple ownership. At the federal level, three separate agencies (the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation) administer four sweeping statutes and a number of important auxiliary ones.

In a study conducted for the Federal Deposit Insurance Corporation, Stanford Law School Professor Kenneth Scott surveys the division between federal and state authority in banking in seven states with widely divergent regulatory schemes. He concludes that while federal dominance has been on the rise, there is a considerable field of jurisdiction still left to the states, its exact boundaries resulting more from political than from economic pressures.

Scott groups the various areas of bank regulation into five major categories, according to the objectives underlying, or at least used to justify, them: ensuring the safety of depositors' funds, preserving competition, protecting consumers, protecting stockholders, and allocating credit. He then classifies the relationship between federal and state regulation in each case into one of four different patterns:

1. *Federal dominance,* where a federal rule applies to both state and national banks, to the exclusion of (or in the absence of) any state rule on the same matter.

2. *Overlay,* where a bank must comply simultaneously with both a federal rule and a state rule; state banks are particularly likely to encounter this pattern.

3. *Independence,* where a federal rule applies only to national banks and a state rule applies only to state banks.

4. *State dominance,* where a state rule governs for both state and national banks, either by express incorporation in the federal statute or by tacit federal acquiescence.

Congress's power to decide which pattern will prevail in a given area is virtually complete for national banks, and nearly as extensive for state banks. Because national banks are "federal instrumentalities," Congress has a free hand in regulating them in any constitutionally acceptable way, defining as large or small a domain for state laws and regulations as it cares to. On some matters, Congress has quite explicitly authorized or prohibited state regulation. More commonly, Congress has not addressed the issue, thereby leaving it to the courts to work out the state role.

The courts have followed a modest strategy of allowing state regulation to operate on national banks except where it would impair their effectiveness or interfere with a pervasive federal regulatory scheme. Scott holds that, given the doctrines of federal instrumentality and federal supremacy, Congress clearly can override state regulation of national banks to whatever extent it sees fit. But in the absence of any express congressional declaration, it is less clear when and where the courts will find the "functional impairment" necessary to justify federal preemption.

State banks, argues Scott, are probably equally subject to congressional control under existing legal precedents. Congress has long employed the indirect device of attaching regulation of state banks to an optional federal benefit, such as insurance of deposits, but in doing so it has not forsworn direct regulation. Many of the recent "consumer protection" measures include uninsured banks within their coverage. Few cases, though, have tested the constitutional limits, if any, to federal control of state banks.

Scott examines the division between federal and state control in each major area of

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bank regulation. He finds that federal domination has become the most widespread pattern, especially in the new regulatory areas opened up in the 1960s and 1970s. In its effect on banking operations and profitability, however, state regulation remains quite important. The reason is that chartering, branching, and the establishment of usury ceilings, all traditional areas of state autonomy, are key influences on bank profitability.

It is not easy, Scott suggests, to make sense of the patchwork quilt of bank regulation in terms of logic or efficient public administration. Historically, he says, it is much more plausibly understood as the result of the differing political strengths of contending groups—large and small banks, depositors, debtors, competitors—at the state and the federal level, and of the scope of regulation necessary to achieve a dominant group's economic objectives.

Import Protection: Weighing the Scales

Effects of Restrictions on United States Imports: Five Case Studies and Theory by Morris Morkre and David G. Tarr, Bureau of Economics, Federal Trade Commission, June 1980.

Protectionism is often defended as a way to avert the costs of adjustment incurred by U.S. workers and industries displaced by foreign competition. In this report, Federal Trade Commission economists Morris Morkre and David Tarr attempt to assess those adjustment costs and compare them with the costs that protection imposes on consumers and the economy through higher prices and inefficiency. They conclude that protectionism's costs have been significantly greater than its benefits.

Traditional forms of protection (such as tariffs and import quotas) and newer forms (such as orderly marketing agreements) can be viewed as a type of regulation, Morkre and Tarr point out. In the five industries they studied, all subject to severe import pressure, protectionist measures ranged from largely ineffectual (in the case of color TVs) to stringent (textiles). The ratio of inefficiency costs to benefits ranged from a low of 3½:1 (sugar) to highs of 25:1 (footwear) and 400:1 (citizens' band radios).

Morkre and Tarr include in their estimates of inefficiency costs not only the "dead-weight losses" of inefficiency but also transfers from U.S. consumers to foreign producers and governments, which are a loss to the United States but not to the overall world economy. The full cost to U.S. consumers is for each industry a much larger figure, most of it representing a transfer to domestic producers and to the U.S. government. Morkre and Tarr's estimates of benefits include only the production that would be forgone if imports were permitted and workers consequently lost their jobs. For both costs and benefits, the authors used the present values of four years' worth of costs and benefits (except in the case of CB radios, where the tariff ends after three years).

President Carter imposed a tariff increase on CB radios for the years 1979–81, temporarily moving the basic 6 percent rate to 21 percent for the first year, 18 percent for the second, and 15 percent for the third. Morkre and Tarr estimate consumer losses attributable to the additional duties at $114 million, of which production and consumption inefficiency waste (dead-weight losses) represent $26 million. Compared to other industries such as steel and automobiles, Morkre and Tarr believe, the earnings losses of displaced CB workers are small—only $60,000 in all. As a result, they estimate, the costs of the tariff exceeded the benefits by 400 to 1.

Sugar imports are subject to a tariff whose level is linked to a parity price index for domestic sugar. The duty on raw sugar was 1.875 cents a pound during 1977, or 21 percent (it went up to 62 percent the next year, partly due to a depressed world price). The authors estimate the cost to consumers over four years, assuming that the 1977 rate prevailed, at $1.56 billion. Of this, $155 million was inefficiency losses, and the remainder was shared equally between government duty collections and gains to U.S. sugar interests. The tariffs were estimated to save workers $45 million, all in the first year. Thus the inefficiency costs of the tariff are approximately 3½ times the benefits.

In mid-1977 the United States negotiated orderly marketing agreements (OMAs) with two of the fastest growing exporters of non-rubber footwear: South Korea and Taiwan. The OMAs, which are voluntary bilateral agreements to restrict imports, were superimposed

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on the existing tariff structure. According to the Morkre-Tarr estimates, the annual inefficiency losses attributable to the existing tariff amounted to $11 million. The OMAs imposed a much greater burden: $115 million in inefficiency for the first year alone, and $589 million over four years; the total cost to consumers was $1.025 billion over four years. The significant feature about the OMA inefficiency cost was that most of it, some $91 million in the first year, went to monopoly profits (or scarcity rents) retained by South Korea and Taiwan. The averted earnings losses of U.S. footwear workers came to $23 million, less than one-twenty-fifth of the inefficiency costs. Since South Korea and Taiwan specialize in lower-priced footwear, Morkre and Tarr argue that the OMAs are likely to disadvantage lower-income consumers disproportionately.

The United States restrains textile imports through eighteen bilateral agreements negotiated with textile exporting countries under the multilateral Multi-Fiber Arrangement. Lack of data made it impossible to assess the effects of the quantitative restraints on textile trade imposed by the pacts. Instead Morkre and Tarr estimated the welfare costs of the U.S. tariff on apparel, which represents about two-thirds of all textile imports. They found added costs to consumers from the tariff on apparel to amount to $5.07 billion, of which $1.53 billion was inefficiency losses. The total adjustment cost saved for otherwise displaced apparel and textile mill workers came to $213 million, slightly less than one-seventh the costs.

The final case study illustrates the difficulty of making any firm predictions about the effects of import control. In 1977 the U.S. government negotiated an OMA with Japan that cut Japanese imports of color televisions by about 40 percent, or 1 million units a year. The consequence was a surge in color television imports from South Korea and Taiwan and in imports of incomplete sets from Taiwan and Mexico. Morkre and Tarr state that this occurred partly because the OMA encouraged the formation of color television industries outside Japan and partly because the Japanese yen rose dramatically against the U.S. dollar. As a result, total imports of color TVs actually increased, and there was no rise in the U.S. price. The OMA thus generated little in the way of either costs or benefits to U.S. consumers.

In recent years, the authors maintain, the United States, Europe, and Japan have embraced a "New Protectionism." This has taken the form not of tariffs (which actually have declined) but of quantitative restrictions such as OMAs, sector agreements, and antidumping restrictions. The footwear example may indicate, the authors say, that such nontariff barriers are even more costly to the country imposing them than are tariffs. While a tariff at least generates revenue for the home government, the monopoly profits generated by quantitative barriers are kept by foreign producers and governments.

Statistical Analysis in the Courtroom

"Multiple Regression in Legal Proceedings" by Franklin M. Fisher, and "The Judicial Reception of Multiple Regression Studies in Race and Sex Discrimination Cases" by Michael O. Finkelstein, in *Columbia Law Review*, vol. 80, no. 4 (May 1980), pp. 702-736 and 737-754.

Once the arcane preserve of statisticians, multiple regression analysis—which seeks to quantify the effects of different factors on some variable—has increasingly found its way into the courtroom. These two articles examine the uses and abuses of this analytical technique, including the ways litigants often select data bases and methodologies favorable to their case.

Economist Franklin Fisher of the Massachusetts Institute of Technology explains regression analysis, some of its assumptions, and its role in resolving factual disputes in fields as diverse as antitrust and railroad safety; regressions are also employed in regulatory rulemakings, as in the Federal Communications Commission's proceedings on cable TV. Michael Finkelstein of Columbia Law School looks in detail at how multiple regression has been used so far in discrimination lawsuits. When both parties submit regressions using different data bases and assumptions, the court can be left with the formidable task of reconciling the competing models; Finkelstein proposes pretrial determinations to resolve disputed methodologies and sharpen the focus of subsequent arguments.

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(Continued from page 4)
shrinkage of their jurisdiction. Note, for instance, that few important agricultural states have comprehensively exercised their right to regulate labor relations in agriculture.

OSHA and Benefit/Cost

TO THE EDITOR:

In their article on OSHA's noise standard, "Protecting Workers' Hearing" (*Regulation*, September/October), James C. Miller III and Thomas F. Walton seek to demonstrate the usefulness of a cost-benefit framework in judging the "economic feasibility" of OSHA standards. In this case, the authors conclude that OSHA's noise abatement program of engineering controls is less cost-effective than a GM program which uses personal hearing protectors. They base this assessment in part on unsubstantiated assumptions about the effectiveness and cost of such devices.

Most analyses to date have ignored the wide-ranging differences in reliability and comprehensiveness of protection among alternative control technologies. For example, the Miller-Walton analysis focuses exclusively on technical differences in noise reduction levels between engineering controls and personal protection devices. They do not take into account some of the major drawbacks of personal hearing protectors: higher failure rates, the need for employee monitoring and supervision, and, most importantly, the fact that many workers cannot or will not wear them.

A number of studies show that many workers would not receive the 26.6 dBA noise reduction from hearing protectors assumed by Miller and Walton. For example, a recent NIOSH-sponsored study in actual industrial settings found much lower median reductions of 7.5, 10.0, and 12.8 dBA for the three earplug types listed. Other studies have found ear protector rates of noise reduction as high as 33 dBA for one type of earmuff and as low as zero in other cases.

In its regulatory analysis, OSHA assumed that the average ear protector provides 15 dBA of noise reduction. If so, the average exposure levels under the GM program are seen to be similar to, not lower than, the level under the OSHA program. Moreover, OSHA assumed a full-scale program of worker training and audiometric testing to instruct workers on the need for and proper use of the protectors. Allowing for a less comprehensive program would increase the relative benefits of the OSHA approach. The benefit estimates are likewise highly dependent on the values assumed for the effectiveness of engineering controls. The sensitivity of these cost-benefit results to defensible changes in assumptions shows both the potential for misleading health determinations and the real subjectivity underlying such analytical techniques.

Even the cost side of the equation, often characterized as relatively precise, is in practice subject to wide-ranging estimates. For example, the authors assume that noise reduction enclosures will have a useful life of only five years. Yet other research conducted by Bolt, Beranek and Newman (BBN), a nationally recognized acoustical consulting firm, indicates that noise controls last about 20 years, substantially reducing the estimated costs of engineering controls.

The authors compared the estimated costs of the OSHA standard for GM with those in the *Continental Can* case, where a court ruled that a noise abatement program costing $410 per employee was "economically infeasible." Comparisons between imprecise and *ad hoc* court rulings are especially dangerous and would hardly lead to improved regulatory decisions.

The danger in imposing a cost-benefit requirement for OSHA regulations lies in giving a false semblance of objectivity to the uninitiated. Although cost-benefit analysis is attractive and sensible in theory, it is not as precise and value-free in practice as its proponents often suggest; it cannot replace the complex subjective judgments necessarily involved in occupational health and safety regulation. This is meant to suggest not that economic efficiency should not be a primary consideration in regulatory policy, but rather that cost-benefit analysis is a very imperfect tool for making efficiency judgments.

Nancy S. Barrett
Department of Labor

TO THE EDITOR:

. . . I would call the Miller-Walton article a cost-*effectiveness*, not a cost-*benefit*, analysis. The benefits of regulation were specified in physical terms, and not in the "willingness to pay" terms of a true cost-benefit comparison. Were a cost-benefit analysis done on *both* the GM policy and the OSHA alternative, *neither* might pass muster. Workers might find that the disutility of possible hearing impairment is less than the disutility of having to wear ear protection.

Of course, with regard to other regulatory policies, a cost-benefit analysis might suggest that all the alternatives, including the one judged most cost-effective, are too weak; more and not less regulation might be deemed more efficient on cost-benefit grounds.

I hope that the distinction between cost-benefit and cost-effectiveness analysis is made clear in any future legislation requiring such tests. We should also require consideration not only of distributional consequences but also of whether a governmental role is necessary in the first place. Otherwise such legislation may lead to a flood of misleading studies—some of which might serve only to identify the most cost-effective way of wasting the taxpayer's money.

Henry M. Peskin
Resources for the Future

JAMES MILLER III and THOMAS WALTON respond:

Regarding Dr. Peskin's comments, we felt our analysis of the OSHA proposal covered both its benefits, which were negative, and its costs, which were positive and much higher than the existing GM program's. We also showed that using personal protective devices could prevent hearing impairment at a much lower cost. Thus ours was both a benefit-cost and a cost-effectiveness analysis.

We would be the first to agree with Dr. Barrett that benefit/cost analysis is only as good as the assumptions upon which it is based and that there will almost inevitably be subjective factors that cannot be quantified well, but which nonetheless must be incorporated, explicitly or implicitly, in the final decision. However, in the present instance even adopting all of her assumptions would not affect our conclusions. That is, the OSHA proposal would still provide no improvement in worker protection at an annual cost of $9,424 per worker —a number that is 23 times the magnitude found economically infeasible in the precedent-setting case, *Continental Can*, and which can scarcely be deemed cost-effective by any standard.

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Our "assumption" of the noise reduction afforded by the hearing protectors actually used by General Motors employees comes from the National Institute of Occupational Safety and Health's publication 76-120, which lists the mean and standard deviation of performance of hearing protectors as tested by independent laboratories utilizing American National Standards Institute testing procedures. The publication suggests adopting a protection factor two standard deviations from the mean, which "[s]hould rarely overestimate the degree of protection." The 26.6 dBA we used was nearly three standard deviations from the mean, and was also in agreement with values used by the OSHA Review Commission in *Continental Can.*

The "recent NIOSH-sponsored study" (NIOSH publication 79-115) referred to by Dr. Barrett attributed its results to workers' using the wrong size earplugs and/or improperly inserting them. It cautions that its results were based upon a limited sample and advised against "extrapolation to the general case. . . ." Unlike the plants which were the subject of that study, General Motors maintains a plant physician and an audiologist, who oversee the fitting of hearing protectors and monitor the effectiveness of the hearing conservation program.

Regarding Dr. Barrett's criticism of the five-year useful life assumption for machine enclosures, it should be noted that her suggestion of 20 years would have little impact on our total annual cost estimate, which would decline from $10,700 per employee to the $9,424 previously indicated. We regard the five-year assumption as quite conservative, based upon actual experience in the auto industry, in which rapidly changing products and production processes dictate at frequent intervals new sizes and shapes of machines and, hence, machine enclosures. In addition, enclosures that are often removed and replaced for machine maintenance suffer substantial wear and tear.

Regarding the criticism of our use of "imprecise and *ad hoc* court rulings," such as *Continental Can*, we would simply note that the Occupational Safety and Health Review Commission has found that decision to be "dispositive."

However, the most disquieting aspect of Dr. Barrett's letter is the rationale she employs to dismiss reliance on benefit-cost analysis. She correctly points out that economic efficiency should be a primary consideration in setting regulations. But when confronted with a regulatory tool that makes explicit the assumptions, methodology and analysis it employs, she complains that it is misleading, imperfect, imprecise and value-laden. Instead, she says, we must rely on "complex subjective judgments." In our judgment, Dr. Barrett's reasoning on this point is indicative of much of what has been wrong with OSHA regulation. In overturning OSHA's decision and requiring benefit-cost analysis, the appeals court in the RMI decision had some pointed comments on this approach: "The Secretary [i.e., OSHA] . . . considers engineering controls preferable to personal protective devices since the former are not as subject to the human element as the latter. We question the reasonableness of this highly paternalistic attitude. . . ."

Contrary to Dr. Barrett's contention, benefit-cost analysis *must* intrude on the regulatory process if economically efficient solutions are to be achieved. Indeed, the fact that our conclusion would be unaffected by a vastly different set of assumptions (which were much more favorable to OSHA) points up the weakness of OSHA's approach and the usefulness of benefit-cost analysis in public policy.

Barbering in Arizona

TO THE EDITOR:

On reading Jonathan Rose's article ("Controlling Clip Joints," July/August 1980), we were dismayed to find that he frequently forgot to tell the whole story or, at the least, misread the plot. Here are a few examples:

- The purpose of the Board of Barber Examiners' concern about sanitary conditions in barber shops *is* to protect the consumer. And our inspections have gotten tougher in the last two years, with the number of violations jumping from 78 in 1978 to 330 already in 1980. Consumer complaints are quickly investigated and resolved.
- Mr. Rose's point that it takes more classroom hours to become a barber than to become a lawyer is somewhat shallow when one considers that the law student must have six years more formal education than the barber before even beginning the 1200 or so hours of professional training with an equal amount of personal study time. Requiring a tenth-grade education is obviously less restrictive to entry than requiring an undergraduate degree.
- Who is better qualified to examine barber applicants than barbers (or to examine candidates for the bar than lawyers)? What Rose did not say about the Barber Board is that it mediates between *barbers*, as does a bar association when it regulates miscreant lawyers. . . .
- Rose is quite wrong that the worst that can happen to the customer in the barber's chair is "four to six weeks of unsightly hair (or nicked chins or even painful skin rash)." The trend toward more permanent waving means an increased use of chemicals. In untrained, incompetent hands serious damage may occur, perhaps even blindness. Examination and subsequent licensing of barbers trained in all services helps prevent not only consumer dissatisfaction but also serious harm.

It is no mystery why the number of barbers has not grown as rapidly as Arizona's population. . . . As styles shifted to longer hair and fewer (if any) haircuts and as unisex beauty shops proliferated, the demand for barber services diminished. . . .

Christine L. Bloom,
Arizona State Board
of Barber Examiners

JONATHAN ROSE responds:

Miss Bloom misses the main point of my article—that what may have started out as an effort to protect consumers has long since evolved into something else. Many of the regulations, as the article demonstrates, have absolutely nothing to do with safety, or with ensuring sanitary conditions in barber shops, or with any other kind of consumer protection. Second, one need not even compare barber education with legal education to know that it is simply absurd to require 1,250 hours of instruction before a person may become an apprentice, let alone a licensed barber. Finally, because of the temptations of economic self-interest, there are serious problems in permitting barbers to examine barber applicants—or in permitting lawyers or any other group to examine those who seek to become their competitors. Control of licensing can too easily become a scheme for restricting competition rather than a means of ensuring consumer welfare. ■

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